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# **U.S. POLICY TOWARD RUSSIA, PART II: CORRUPTION IN THE RUSSIAN GOVERNMENT**

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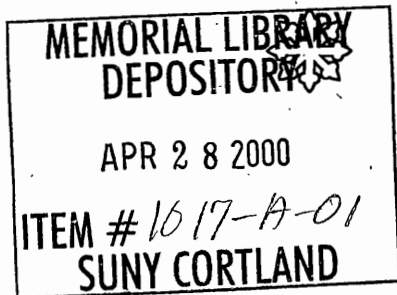
## **HEARING BEFORE THE COMMITTEE ON INTERNATIONAL RELATIONS HOUSE OF REPRESENTATIVES ONE HUNDRED SIXTH CONGRESS**

**FIRST SESSION**

**THURSDAY, OCTOBER 7, 1999**

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## **U.S. POLICY TOWARD RUSSIA, PART II: CORRUPTION IN THE RUSSIAN GOVERNMENT**

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**Thursday, October 7, 1999**

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON INTERNATIONAL RELATIONS,  
*Washington, D.C.*

The Committee met, pursuant to call, at 10:15 a.m., in Room 2172, Rayburn House Office Building, Hon. Benjamin A. Gilman (Chairman of the Committee) presiding.

Chairman GILMAN. The Committee will come to order.

I have no doubt that the corruption within the Yeltsin government and within Russia is extensive. Our hearing this morning will seek to assess just how widespread that corruption is, and how high it goes. I suspect that it goes to the top of the Russian government. I will cite just a few cases and reports that would lead one to that conclusion:

The Swiss investigation into the financial links between top Kremlin staff and President Yeltsin's family and a little-known Swiss company called Mabtex.

The Swiss investigation into links between the Russian airline Aeroflot, whose vice president is President Yeltsin's son-in-law, and Swiss companies set up by Russian tycoon Boris Berezovsky, to which Aeroflot's hard currency revenues have been diverted.

A decree issued by Mr. Yeltsin in the early 1990's granting a sports foundation set up by a close friend an exemption from export and import taxes that, in turn, allowed that foundation to retain an estimated \$4 billion or more that would otherwise have gone to the government in tax revenues.

As reported in a comprehensive review by U.S. News and World Report magazine, an investigation was begun by our FBI in 1994 into the activities of a company called Golden A.D.A., which was set up by a top official and a close associate of President Yeltsin's in San Francisco. After its establishment, that company shipped tens of millions of dollars worth of diamonds, gold, and antiquities out of the so-called "Kremlin vaults" and sold them, with the money allegedly disappearing into high-priced real estate and foreign bank accounts.

The 1996 arrest of a top aide in Yeltsin's re-election campaign who was caught leaving the Russian Government House in the company of a reputed Moscow Mafia figure and holding half a million dollars in cash in a briefcase, an arrest that never resulted in any prosecution.

Then the notorious "loans for shares" privatization program of 1995 and 1996, under which the crown jewels of Russia's oil and

metals companies, such as Sidanko and Norilsk Nickel, were sold to Russia's tycoons for a mere pittance.

Then there were allegations linking a former Yeltsin government representative at the International Monetary Fund to the ongoing investigation into the possible laundering of billions of dollars of Russian moneys through the Bank of New York.

We have also learned recently of the use, by the Russian Central Bank's top officials, of an offshore company called FIMACO for financial purposes that may yet not be fully understood.

Then the alleged massive corruption in the Russian military that cost the lives of, first, a young reporter and, second, a member of the Russian parliament, both of whom sought to bring that corruption to light.

I should note that this is by no means a full or comprehensive list.

But let me turn to another question we should be considering. In a hearing this Committee held yesterday, one of our witnesses, a former analyst for our intelligence community, stated his suspicion that there may be American partners having some self-interest to make certain that IMF moneys continue to flow to Russia, as Russian moneys are siphoned out of its government and economy and into western banks and accounts. That suspicion is something we should be looking at with great concern.

As our Members may know, our Department of Justice is now investigating allegations that personnel of a top AID contractor in Russia, the managers and overseers of our U.S.-financed privatization program in that nation, engaged in personal investment activities while carrying out their work for our government in Russia.

In 1996, before that Justice Department investigation began, I commissioned an investigation by the United States General Accounting Office into the work of those managers in Russia out of concern that the Administration may have channeled \$40 million in noncompetitive grants to them. As the Justice Department's investigation was beginning, we also asked the GAO to look into the activities in a key subgroup of the Gore-Chernomyrdin Commission of one of those allegedly under investigation by AID and Justice. At the request of the Justice Department, however, we later suspended that GAO investigation.

I now note, however, that press reports have alleged that another American under investigation in this matter by Justice has been named in a lawsuit that alleges that a pricing conspiracy was organized to siphon off millions of dollars from a Russian company into offshore accounts.

I mention this matter today because I believe we should be interested and willing to learn whether we have not just a Russian corruption problem, but whether, in fact, there may be something of an American problem as well.

As one Russian analyst has stated, it is interesting that one American firm managed to obtain over 10 percent of the vouchers that were issued under the Russian privatization program set up with American assistance in the early 1990's. The question is how such things have come to pass.

[Prepared statement of Chairman Gilman appears in the appendix.]

Before I recognize our Ranking Minority Member, Mr. Gejdenson, for any opening remarks he might like to make, I would like to briefly introduce our distinguished panel of witnesses.

First, we will be hearing from Mr. Richard Palmer, who is retired from the U.S. Central Intelligence Agency Operations Directorate. His last assignments for the agency were in the region of the former Soviet Union.

Our next witness, Mr. Keith Henderson, is Co-Director of American University's Transnational Crime and Corruption Center, and served as the U.S. Agency for International Development's Senior Adviser on Rule of Law, Crime and Corruption, with the Agency's Bureau on Europe and the Independent States.

Our third witness, Mr. David Satter, is a visiting scholar at the Johns Hopkins School for Advanced International Studies, Senior Fellow at the Hudson Institute, and has written extensively on the issue of corruption in Russia.

Our next witness, Mr. Matthew Murray, is the President of the firm Sovereign Ventures, which has offices in Washington, DC and St. Petersburg, Russia.

Finally, our last witness, Mr. Konstantin Borovoi, is a member of the Russian parliament whom I am pleased is able to be here with us today to give us a Russian perspective on this issue, which is important not just for Russia, but for America as well.

I now recognize our Ranking Minority Member, Mr. Gejdenson, for any opening remarks he might like to make.

MR. GEJDENSON. I think it is clear that there is no surprise that a society which, for 50 years, lived under a totalitarian regime has had serious adjustment problems in trying to develop a civil society and democratic institutions with transparent laws dealing with accountability.

We have some of those problems in our own country, of course. A citizen of my State just left with \$200 million of investors' money and ended up in, I think, Germany for a short stay before our government convinced him to come back.

If you talk about losses—I forget the name of the company, again not in my district in Connecticut but in the western part of the state—there was a hedge fund that seemed to have lost somewhere to the tune of \$3 billion. So the fact that there is crime, corruption, and thievery in a society that has gone through the transitions that Russia has gone through shouldn't shock us.

Given that, and I will do something I generally don't do, I am going to quote something from a former Secretary of State, James Baker, who said that it clearly follows that engagement with Russia is the only sensible approach in dealing with the problems she faces and the strains in our relationships. A peaceful, democratic, and prosperous Russia is strongly in our national interest, and it is clear we need to continue to work on the numerous initiatives that we have begun.

We need to make sure that when there are assistance programs, that the money really goes where it is intended to go. We need to make sure that the Russians set up a law enforcement system that functions with the kind of judicial code and criminal code that most of the civilized world functions in. We need to make sure that de-

velopment occurs not just by who is politically connected, but by who has the best chance economically.

Russian corruption is a serious problem. We cannot minimize it, but I certainly hope that the hearings that this Committee and the Banking Committee are holding are not some attempt to politicize what is an obviously difficult transition that no one should be surprised would occur.

We have important issues at stake here. We want to make sure we stay engaged. We want to make sure that, like many of the things done in the Gore-Chernomyrdin meetings, we deal with the issues of setting up bureaucracies that are responsible, that follow the law, and that carry out the interests of the Russian people. We are better off with a Russia that works than one that doesn't work, and I hope we will learn, from these hearings, more of what we can do to be helpful.

Chairman GILMAN. Thank you, Mr. Gejdenson.

Do any other Members seek recognition?

If not, we will proceed with the testimony.

Before we begin with our testimony, I ask unanimous consent that a written statement on the issue of corruption in Russia, submitted by Professor Lynn Nelson of Virginia Commonwealth University, be inserted in the record at the end of our witnesses' testimony. Without objection. Professor Nelson has written extensively on the subject, but was unable to appear before the Committee this morning.

Chairman GILMAN. We will now hear from our witnesses.

Mr. Richard Palmer holds a Master's Degree in international relations from the University of Southern California. He served over 5 years with the U.S. Army, including service as an infantry officer in Vietnam, and then served with the U.S. Central Intelligence Agency's Operations Directorate for 20 years, with his last assignments with the agency focusing on the former Soviet Union. Mr. Palmer now heads up an investigative firm specializing in asset recovery, business intelligence, and due diligence work.

Welcome, Mr. Palmer. You may summarize your written statement, which, without objection, will be inserted in the record. Please proceed.

**STATEMENT OF RICHARD PALMER, PRESIDENT, CACHET INTERNATIONAL, INC., U.S. CENTRAL INTELLIGENCE AGENCY, RETIRED**

Mr. PALMER. Thank you, Mr. Chairman, and other Members of the Committee. I welcome the opportunity to address this Committee on a subject that presents serious threats to Western nations, as well as involving the use of U.S. taxpayers' funds to continue the looting of the Russian state.

After 25 years' government service, I retired from the CIA in 1994 and I then spent another 2½ years in the former Soviet Union. I felt that the subject of Russian organized crime, official corruption, and the peculiarities of their developing financial system deserved more attention, and we needed more information on it. Therefore, I spent 2½ years researching that.

I worked briefly in training, as a training director for a Russian bank—nothing to do with accounts, nothing to do with their busi-



ness—and then I worked on behalf of some Russian-European banks in the former Soviet Union.

I can say that during that period of 1994 until I returned to the United States at the end of 1996, finding information about Russian organized crime was not difficult. Indeed, I gathered hundreds of pounds of documents. Now, this was outside of any official capacity after my retirement, as basically a normal businessman, a normal person. What I am saying is the information was there if anyone wanted to look.

You must remember that when I returned to the United States, I felt that I had something particularly valuable because I had direct insight into corruption, not only in Russia, but some of the former republics, and I had some detailed knowledge of how Russian organized crime worked and also how Russian organized crime worked in moving not only funds to the United States but creating companies in the United States through which to transfer their funds back to Russia.

Now, I am speaking here of only a small amount of funds. There is a gentleman at Brookings Institute who has done a thorough study of money laundering and capital flight; and he agrees with my findings—although he has done much more research—that an extremely small percentage ever goes back to the country that it left. He asked a Russian official once does any of this money ever come back, and the Russian official immediately answered *nyet*, *nyet*. Then he thought a moment and he said, well, there was one idiot who brought some money back to buy GKO's, but very small amounts.

When we talk about some of the American investment in Russia, sometimes we are talking about Russian organized crime funds that are going back under the guise of the U.S. corporations, which is then looked at as U.S. investment and also as, then, a responsibility for the U.S. Government to protect.

There has been very little research into that area. In 1996, when I returned, I offered to talk to U.S. intelligence agencies, U.S. law enforcement agencies, and I was told that this was not a problem, there had been corruption, but the problem had been basically solved and that, boy, if you had come in 1992, this would have been interesting. Now, the problem is solved. We would not be here today if the problem were solved.

Very quickly, this is a current problem that is going to go on into the future. The idea that this is like Chicago in the 1920's, and this will also evolve into good legitimate money like our robber barons is nonsense. As I mentioned in detail in my testimony before the House Banking and Financial Services Committee, this would be as if they controlled the entire government, the Federal Reserve, all the police, the Congress. Why should they change?

I can tell you that they are not only not going away, if we look at the subject of spent nuclear fuel for which the United States has set aside hundreds of millions of dollars, there are Russian organized crime-connected groups, companies, right now, who are getting ready to bid for that money. They are looking to the future. Unfortunately, we have not been as far-seeing as them.

In watching the recent television hearings—and I must say I don't vote regularly, and this is not a partisan hearing—but I was

watching the TV show about the biography of President Reagan, and he kept referring to this term of "trust but verify," and I think we have lost track of that. We have not verified where the funds have gone. We have not tied our funds to a quid pro quo. We don't even have a treaty to protect U.S. investors at a time the government is still promoting U.S. investment in Russia and the former Soviet Union. The European Union has one, because they said you don't get investment from us until we have the treaty.

As you are aware, there has been no movement on a money laundering law in Russia. In fact, the last two attempts have been vetoed by President Yeltsin. I am rather reliably informed that there has been a decision in Russia that, following the scandal of the Bank of New York and money laundering in the United States, you will see a watered-down money laundering bill before the end of this year. There is a cause-and-effect relationship here.

The Russians have a phrase that says, the guy who pays for dinner picks the meal. I think we should be able to put some requirements on this. Like our food assistance program, the Administration did everything possible to make sure that that food was not traced. Frankly, large amounts of that are going to go for graft, and that is very easily shown.

The last thing I want to say is that we now see a government that, I think, Yeltsin and the circle around him, it is rather well documented, the level of corruption. You have the new Prime Minister, Putin, who allegedly left the KGB a few months after the KGB issued a directive asking its officers to go out and found companies to move money.

One of a few ways of moving money was the sale of what they call tolling, using intermediary firms to buy Russian resources, particularly nonferrous metals. Mr. Putin's first job was giving permits to sell nonferrous metals. After that he worked for Mr. Borodin, which was the office in charge which had the contracts with Mabetex. I believe he was chosen because if any of those areas are prosecuted he also is in danger.

What I am saying is that the corruption is rampant through the government. It has been obvious for a long time. I hope we will focus on it. I am not calling for disengagement. Russia is too large, it is too important. But we have to take a closer look. We have to be honest, and we have to be objective.

Corporate America has tried to look the other way as well. Corporate America has also said, well, we can assume that we can continue to make 200 percent a year on GKO bonds and, if anything happens, IMF funds will bail us out, so it is a protected investment. I am afraid that there has to be an investment site like any other. We have to be more realistic and depersonalize this. This is not a matter of a few officials on the other side having a personal relationship. This is something where our Congress should literally have more direct contact with their government. We have to work together with them.

The last point I want to make is, when we consider Russia, we must also remember that not all of the former republics became instant democracies overnight. In fact, some of the former republics are literally more corrupt than Russia. While we are on this downhill race to bring these people into the European Union and to

bring them into NATO, I think that we should seriously stand back and look and see if we should not ask for more development in these countries, and more proof that they are on a democratic path before we bring them into organizations they can weaken or dilute.

I thank you very much for allowing me to make these comments today.

Chairman GILMAN. Thank you Mr. Palmer.

[The prepared statement of Mr. Palmer appears in the appendix.]

Chairman GILMAN. Our next witness is Mr. Keith Henderson, Co-Director of American University's Transnational Crime and Corruption Center. He served as the U.S. Agency for International Development's Senior Advisor on Rule of Law, Crime and Corruption in the Agency's Bureau for Europe and the New Independent States. Mr. Henderson has also participated in the State Department's Policy Working Group on Corruption, he has written on corruption, and is a member of the United Nations' Expert Group on Corruption.

Mr. Henderson, you may summarize your written statement which, without objection, will be inserted in the record. You may proceed.

**STATEMENT OF KEITH HENDERSON, FORMER SENIOR ADVISER ON RULE OF LAW, CRIME, AND CORRUPTION, U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT, CO-DIRECTOR, TRANS-NATIONAL CRIME AND CORRUPTION CENTER, AMERICAN UNIVERSITY**

Mr. HENDERSON. Thank you, Mr. Chairman, and Members of the Committee.

I first want to apologize. Our computer system crashed yesterday at American University, and I was unable to provide some final edits to the testimony. I notice some grammatical errors, and it arrived late. Again, apologies, but we will make those changes. The good news is that there were too many students on-line, but some of us are wondering exactly what those students were doing on-line.

But I am very pleased to be here today. I will try my best to share my candid thoughts and reflections on my past and current anticorruption work, and welcome your questions.

My main interest is in advancing the global and Russian anticorruption agenda, and in sharing lessons learned during my tenure at USAID and my current activities at American University.

You may know that our center is the brainchild of my esteemed colleague, Professor Louise Shelley, who formed the center in 1995 with seed money from the MacArthur Foundation. Our main objective is to undertake academic and applied research on global crime and corruption problems through creative multidisciplinary partnerships with scholars and practitioners in targeted countries. With support from the U.S. Department of Justice and others, we have now established four centers in Russia and one in Ukraine.

With the Chairman's permission, I will now summarize my testimony as requested.

In 1997, Elena Bonner, former dissident, human rights activist, and widow of the Nobel Peace Prize laureate, Andrei Sakharov, made an observation that I believe sums up the current general

state of affairs in Russia: "The intelligentsia seems to have abandoned its historic calling of compassion and assistance in the favor of grabbing crumbs dropped by the corrupt and powerful."

She noted that while considerable freedoms had been achieved in a relatively short period of time, the collapse of the education and health care systems, forced military conscription, unconstitutional predetention law enforcement policies, abominable prison conditions, and substandard living conditions made many of the former concerns of dissidents look trivial. She called upon the international community and the Russian leadership to refocus its attention on core societal values and goals such as freedom of the press and rooting out corruption. I believe her comments set the stage, not only for today's discussion, but they also argue for a global and anticorruption summit and raise several important questions.

First, is corruption both a Russian and international problem that requires global solutions?

I know this Committee believes that it is, but a historical comment on corruption in Russia. I was at an old bookstore on Capitol Hill a couple of years ago and was delighted to find a book that outlined many of the reforms that were being undertaken by Czar Alexander II in the 1860's, and I think this speaks volumes.

Over 130 years ago, during the early reform era, Czar Alexander defined Russian corruption as a centuries-old problem that was a major deterrent to Russia's integration with the West. The historian observed that the causes of corruption that existed then remained applicable today. He wrote this in 1896: First, it is a society ruled by men not laws; second, a secretive, restrictive bureaucracy that stifles justice and the press, and the development of strong state institutions; third, weak civil society unable to check government action; and fourth, a disdainful citizenry. These are the same core problems facing Russia today.

The political, economic, and social problems facing Russia, the U.S., and the global financial system stem in large part from our collective failure to fully acknowledge, understand, or respond to what is now recognized as one of the biggest threats to global economic growth and political stability—public and private "grand" corruption. This phenomenon has greatly limited the power of the Russian State and others to play a positive role in developing society in countries around the world.

While the effects of grand or high-level corruption have economic and political consequences on all countries, including the U.S., they have a disproportionate impact on developing and transition countries, and any subsequently emerging middle-class. Indeed, many CEOs and policymakers now believe that systemic corruption in developing transition countries such as Russia makes long-term sustainable economic and political development virtually unachievable.

However, most people in positions of power around the world, whether in the public or private sector, have chosen to treat grand corruption much like the global AIDS/HIV epidemic, either under a cloak of silence, or with rhetoric. There are still no serious concerted holistic efforts under way to address this problem. From my perspective, most in the international business community, the family of multilaterals and donors as well as most public officials,

including U.S. officials, are moving too slowly and are behind the learning curve.

In the interest of time I will now turn to the question of when could it be said that we first knew that corruption in Russia was a serious problem. While I think reasonable people can disagree on this fact, I think your summation at the beginning of your remarks outlined many incidents that should have given people notice that this is a very serious problem that we had to handle in a very serious way. However, I would point to several events that, in my mind, made me believe that we were not doing enough to address the problem.

First, was the loans-for-shares scheme in 1995, and the 1994 Yeltsin organized crime decree. In hindsight, most analysts now identify the 1995 loans-for-shares scheme as a clear indication that some of the reformers were working closely with, and had ulterior, self-interested motives. That event, coupled with the 1994 Yeltsin decree, which gave the Ministry of Interior almost limitless powers to arrest and prosecute individuals outside the scope of the new Russian constitution, should have sent important signals to all that organized crime and corruption were occurring at very high levels within the Russian government.

I do not pretend to be an expert on the loans-for-shares scheme and I don't know all the facts intimately. Indeed, I was working in another office at the time at USAID but was watching closely. However, I would like to quote Anders Aslund at Carnegie, who is a well-known and highly respected former Chubais protege and long-time Russia watcher, who said that this scandal "blemished" both Chubais and large-scale privatization in general.

In a recent 1999 Foreign Affairs article, Aslund notes that a few banks were allowed to privatize some enterprises at auctions that they themselves controlled. Many lawsuits and volatile wars among bankers and managers of these enterprises occurred, both during and after the process.

Aslund then goes on to observe that the barrier to reforming Russia has never been the workers or the people, who have been exceedingly complacent. Rather, the threat has always come from elites who want to live on corruption. I concur with this analysis and conclude, like he does, that the best way to control these kinds of forces is through effective democracy.

Another telltale point, I believe, is the congressional testimony before this very Committee in April 1996. During that testimony, my colleague Louise Shelley; as well as the Director of the FBI, Louis Freeh; Eric Seidel, the Deputy Attorney General of New York; and John Deutch, the Director of the Central Intelligence Agency; among others; were among the first to sound the political alarm call that crime and corruption was a very serious issue in Russia.

Director Deutch noted that: "A link existed between the government elite and the criminal elements that was impeding the ability of the Russian Government to meet the population's expectations of social justice, a quality of opportunity, and improved living conditions."

Chairman GILMAN. Mr. Henderson, if I might interrupt, we are in the midst of a vote in the House, and I am going to explain to

my colleagues that we will continue with the hearing right through the vote. I have asked some of our Members to go ahead and vote and come back so that we don't have to interrupt the testimony. Thank you Mr. Henderson.

Mr. HENDERSON. Thank you.

He also noted that the law enforcement forces were understaffed, underfunded, and plagued with corruption. Professor Shelley, Director Deutch, and New York Deputy Attorney General Seidel also testified that organized crime's hold on the Russian banking community was a serious problem that had to be addressed.

Finally, several noted that Russian organized crime was estimated to control up to 40 percent of the Russian economy.

I would say that an awful lot of discussion ensued after I authored a white paper in 1997 that was widely circulated within the U.S. Government that attempted to outline the causes of the problem, and to propose some programmatic solutions. Since that time, as you know, several international conferences have occurred, and many organizations are now involved in this effort.

Finally, I would like to conclude with a few of the lessons I think we have learned from our experience in Russia, which incorporated some comments on the Harvard scandal which you mentioned, and the Bank of New York case.

First, do not attempt to create big or little czars. Putting all of your reform eggs in one basket without broad public participation, support, and oversight is a recipe for failure. It also undercuts fundamental democratic principles and opens up the process to corruption.

Second, insist on transparency within the donor community. On the giving end, the public has a right to know how their money is being spent, and on the receiving end the public has a right to participate in the decisionmaking process and monitoring of this money.

Third, advance an international global anticorruption treaty and minimum terms of conditionality such as my colleague Mr. Palmer mentioned. Donors cannot make specified kinds of loans or participate in certain reforms unless these minimum terms are agreed to in full. Further, adequate support for an independent judiciary, media, and civil society, as well as health and education programs, must be part of this conditionality package.

Fourth, give the OECD antibribery treaty and the OAS anticorruption treaty some impetus and teeth. More intensive, creative monitoring mechanisms that include civil society and business community oversight should be part of this package. In addition, international corporations should be held legally accountable for corrupt complicity. Strengthening key multilateral institutions and enhancing U.S. diplomacy and capacity to implement foreign policy is an essential step in this new world order.

Fifth, enhance international law enforcement cooperation and communication through informal and formal structures and procedures. More regional sector-focused interdisciplinary training programs that are tied to short- and long-term reforms and strategies are needed.

Sixth, promote the flow of corruption information among donors and between donors in the law enforcement community.

Seventh, promote more competition in the public procurement process and the international best practices in good government principles in both the public and private sectors.

Eighth, promote more long-term institution building and reforms related to entities that can provide a check on governmental action.

Ninth, promote policies that promote more cooperation between the executive and parliamentary branches, and more interagency coordination.

Tenth, promote more academic and applied research related to understanding the causes and costs of corruption.

And, eleven, enhance communication engagement within the global and intelligence communities.

Thank you for the opportunity to speak here today, Mr. Chairman.

Chairman GILMAN. Thank you very much, Mr. Henderson.

[The prepared statement of Mr. Henderson appears in the appendix.]

Chairman GILMAN. Our next witness, Mr. David Satter, graduated from the University of Chicago. He was a Rhodes Scholar at Oxford University, and is currently a Senior Fellow at the Foreign Policy Research Institute in Philadelphia.

He is also a visiting scholar at the Johns Hopkins School of Advanced International Studies, and a Senior Fellow at the Hudson Institute.

Mr. Satter served in Moscow from 1976 to 1982 as a correspondent for The Financial Times, and has written extensively on corruption in Russia, and other issues, for the Wall Street Journal and other leading publications.

Welcome, Mr. Satter. You may summarize your written testimony which, without objection, will be inserted in the full record. Please proceed.

**STATEMENT OF DAVID SATTER, VISITING SCHOLAR, JOHNS HOPKINS SCHOOL FOR ADVANCED INTERNATIONAL STUDIES, SENIOR FELLOW, THE HUDSON INSTITUTE**

Mr. SATTER. Thank you, Mr. Chairman.

The reports of massive Russian money laundering through the Bank of New York have awakened Americans to the victimization of the Russian people by their leaders and the possible consequences for the United States if corruption leads to Russia's social and political disintegration. This new-found awareness, however, raises a disturbing question: How was it possible for the Administration to depict the looting of Russia for so long as the progress of democracy, and to back a coterie of corrupt Russian leaders whose actions were actually antithetical to reform?

The answer, I think, lies in the failure to understand that, in the wake of communism, Russia's greatest need was not a correct set of economic policies, but rather the restoration of moral values which was only possible under conditions of the rule of law. By ignoring moral criteria and giving our uncritical backing to a group of leaders whom we identified as reformers, we did not contribute to the welfare of Russia but only to its complete criminalization.

The following is a partial list of the events which should have alerted American policymakers that Russian reform was being carried out in a moral vacuum, and the necessary role of the United States was to defend the rule of law.

First, in January, 1992, prices in Russia were freed, but no effort was made to index savings. The result was that in a few months, 99 percent of the savings of the Russian population disappeared. Persons who had put money aside to buy a car or apartment, or to pay for a wedding or funeral, were left with nothing. Persons who had worked in remote areas of the country where a differential was paid on salaries were now stranded there, in many cases for the rest of their lives.

Second, as the rate of inflation reached 2,500 percent, fraudulent commercial banks and investment companies inundated Russians with advertising offering enormous returns on investment. The government made no effort to limit this advertising or to check on the firms which, in almost all cases, were pyramid schemes, with the result that millions of people with no experience of deceptive advertising or capitalist investment lost their savings a second time.

Third, the government began to allow anyone to export who could get a license. Because Russian raw materials were bought for rubles and sold abroad for dollars, export licenses were akin to permission to print money. In Moscow, they were issued by the Ministry of Foreign Economic Ties which functions like a market, granting the licenses in return for bribes, with the fee for the license insignificant by comparison with the size of the bribe.

Fourth, in a move described as "people's capitalism," the government gave each Russian the right to acquire a voucher which was redeemable for a share in Russian industry. The vouchers, however, were useful only for those who could acquire them in great numbers, and criminal structures began to buy them up on the street, and used them to purchase the most desirable factories, often at giveaway prices.

Fifth, gangsters, businessmen, and corrupt officials in Russia began to work together, in many cases becoming part of a single economic unit.

Sixth, in 1993, President Yeltsin illegally dissolved the Supreme Soviet and, in the wake of a massacre outside the Ostankino television tower, which he may have provoked, persuaded the Defense Minister to authorize the shelling of the deputies who were still holed up in the parliament building. In a vote which is now believed to be falsified, a new constitution was adopted that emasculated parliament and provided for the creation of a new, authoritarian presidential regime.

Seventh, the government began to sell off Russia's enterprises for cash in rigged auctions. If in a rare case there was true competitive bidding and a powerful group was outbid by an insistent competitor, the successful bidder could easily pay for his tenacity with his life.

Eighth, the government launched an invasion of the self-proclaimed independent republic of Chechnya in hopes of having a short, victorious war. Unable to defeat the Chechen resistance on the ground, the regime began the carpet bombing of civilian areas, resulting in the massive loss of innocent life. At the same time,



more than 1,500 Chechen civilians were picked up by Russian interior ministry troops, taken to filtration camps and never heard from again.

Ninth, in 1993 to 1994, the government ceased paying for state orders and began delaying payments on pensions and salaries for state employees, initiating the nonpayment crisis which became Russia's leading source of social tension.

Finally, the government, in the loans-for-shares scheme, began to borrow money from commercial banks in return for shares in desirable, nonprivatized enterprises. The bidding was supposed to be competitive, but, in reality, the shares went to the banks with the closest informal ties to government officials. When the government failed to pay back the loans, which was always the case, it was up to the bank holding the mortgage to organize the sale of the enterprise. In every case, the enterprise then became the property of the bank providing the original loan. In this way, the crown jewels of Russian industry were acquired for a song.

The attempt to transform Russian society without the benefit of either moral criteria or the rule of law led to one of the gravest crises in Russian history. In the resulting atmosphere of moral anarchy, the country was looted. The gross domestic product was cut by half, which did not occur under Nazi occupation.

Russia suffered a demographic catastrophe in the period since 1990—

Chairman GILMAN. Mr. Satter, I am going to have to interrupt you for a moment. We have only a few minutes left for the vote now under way in the House. As soon as one of our Members returns, we will continue, but at this point I am going to call for a brief recess.

[Recess.]

Mr. BEREUTER. [presiding] The Chairman has asked me to resume the sitting of the Committee.

Mr. BEREUTER. Mr. Satter, please continue.

Mr. SATTER. In this situation, there was a historic role for the United States. With the fall of communism, the United States had overwhelming moral authority in Russia and could have insisted on moral practices and the strict rule of law, using political pressure and our influence over international loans. Instead, we used our power, not to advance the rule of law, but to promote the interests of a specific group.

It is often argued that the United States had no choice but to help Yeltsin, and that the only alternative was to help the communists and nationalists. In fact, however, insisting on honesty and fair dealings from the reformers would have been the greatest favor that anyone could have done for them. The reformers lost popularity in Russia not because they backed democracy but because they facilitated the criminalization of the whole country.

The answer now is rethinking our entire approach to Russia, which must begin with an understanding of the moral vacuum that communism left in its wake. Only by recognizing that Russia's first requirement is a structure of law and morality valid for everyone do we have the possibility to lay the framework for real economic reforms capable of saving Russia from its present desperate situation.

If we continue, however, to pretend that Russia is on the path to reform and Yeltsin and his confederates are the embodiment of democracy we may soon find that the growing desperation in Russia will produce a reaction capable of affecting not just Russia, but also the rest of the world.

Thank you. That is the conclusion.

Mr. BEREUTER. Mr. Satter, thank you very much.

[The prepared statement of Mr. Satter appears in the appendix.]

Mr. BEREUTER. Next, we will hear from Mr. Matthew Murray. He served as Legislative Assistant to Senator Edward Kennedy from 1982 to 1984, working on national security issues, and later worked with the law firm of Baker & McKensie from 1988 to 1991. I 1991 he founded the firm Sovereign Ventures Incorporated, which has offices in Washington, DC and St. Petersburg.

Mr. Murray, your entire statement will be made a part of the record. You may summarize as you wish.

#### **STATEMENT OF MATTHEW MURRAY, PRESIDENT, SOVEREIGN VENTURES, INC.**

Mr. MURRAY. Thank you very much, Congressman.

Let me start by saying that I think the reason I have been invited here today is that I have been conducting small business in St. Petersburg for the last 10 years. I lived in St. Petersburg between 1992 and 1998, conducting different types of business; and in the process, because I have insisted on doing business legally and ethically, I have developed a great appreciation for what are the cultural barriers to small business in Russia.

I am also here today to share with you the knowledge that the Russian people have already found the answer to combating corruption, and the answer is the profit motive. It is a powerful motive, and it is particularly powerful when you combine it with the desire to feel good about what you are doing. Many Russian small businesses are gravitating to the idea that conducting business legally and ethically for profit is much more interesting and stable than the alternative.

While it is a potentially powerful force, it also faces huge cultural barriers, as I mentioned. One of the main problems is that the Russian people must learn to be dependent on each other, as opposed to being dependent on the government. The United States can play a vital role in the future by staying engaged and reinforcing the desire of Russian small businessmen and women to get organized and fight to develop accountable government institutions. The U.S. can provide a combination of small grants and ethical business know-how that can help unleash the powerful democratic force that is provided by small business.

Perhaps a useful way of dramatizing this point is to start by comparing Russia with Poland and the Czech Republic. Poland and the Czech Republic have been very successful in removing barriers to small business in the past 10 years. By contrast, during Russia's transition small business has been severely regulated. The most mundane activities are subject to licensing and reporting requirements. Taxes are imposed not simply on profits but also on revenues and the mere movement of capital and goods. A small busi-

ness that challenges government authority risks sanctions and state interference.

The main element in Russian culture stifling entrepreneurs is the unrestrained role of government, not only in regulating the economy but also in profiting from the economy. Many officials in Russia have an expectation of financial reward for serving in public office. Many government positions are for sale, and votes on legislation have an established market price.

During Russia's transition to capitalism this expectation of reward has led to what economists call "rent-seeking." Rent-seeking is conducted by political elites in transitional economies who use their access to power to privatize state property spontaneously at nominal prices and turn state assets into cash by renting them to business. At times rent-seeking takes the form of demand for a bribe or extortion. Often, however, rent-seeking is quasi-legal, making it harder to detect.

The use of public position for private gain didn't start with Perestroika or privatization, nor can it be explained simply by Russia's low government salaries. To comprehend the phenomenon you must first examine Russian history. Due to the absence of a strong idea of the state, government officials have traditionally been inclined and permitted to take care of their personal interests first. The czar's provincial representatives were expected to: "feed themselves from official business." Under Soviet central planning, state resources were exploited by those with access to power, the members of the communist party, whose positions were bought and sold like commodities.

This government behavior takes place against a backdrop of public tolerance and weakened institutions. Traditionally, the Russian people have shown extreme dependency on the government and have been reluctant to hold officials accountable.

Currently, the Russian constitution provides Duma members with immunity from prosecution. Russia lacks an independent judiciary capable of prosecuting government officials, or an independent press capable of protecting investigative journalists. While Russia engages in privatization and other market reforms, official corruption adds a layer of rent on economic activity. Official corruption increases transaction costs for small business and the price of goods and services for consumers.

By imposing an enormous number of different taxes and collecting them arbitrarily, the Russian government extracts additional rent from small business.

At this time in the debate over aid to Russia there is a consensus that the introduction of capitalism needs to be accompanied by the rule of law, but the motivation for legal reform will not come from the Russian government. Historically, Russia's public officials have not relinquished their unilateral powers of interpretation and enforcement. Due to lack of resources and political will, currently the government is unable to enforce existing laws or adopt new legislation to protect small business and private property. Instead, it should be clear that small business itself is the most effective agent for the type of social, legal, and political reform sought in Russia.

To date, Russia's market reforms have failed to produce a middle class. Only small business can fill the missing middle by producing

independent entrepreneurs with a vested interest in a stable and transparent legal system and the determination to hold government officials accountable.

I am pleased, therefore, to have the opportunity to appear before the House Committee on International Relations at this stage.

To reduce official corruption and otherwise sustain market reform in Russia, the Russian people must be empowered to remove all barriers to small business. Russia doesn't need western financial capital as much as it needs social capital—that is, the trust and shared values among individuals, businesses, and government officials which are the very foundation of a market economy. Social capital accrues at the grassroots level through the creation of voluntary organizations such as business, trade, and professional associations, rotary clubs, church groups, charities and nongovernmental organizations. As small business must work together to break down market barriers, they are a natural catalyst for the formation of such voluntary organizations.

Due to the special value Americans attach to small business and the rule of law, the United States has already been acting to create social capital in Russia by helping to build voluntary organizations, to reinforce traditional Russian ethics, and to shape government institutions which are accountable. For example, in September 1998, the Eurasia Foundation, a nongovernmental foundation funded by AID, provided Sovereign Ventures an \$88,000 grant to begin a private sector initiative to promote business ethics.

The grant helped St. Petersburg small businesses create the Declaration of Integrity in Business Conduct, a voluntary statement of international business principles and practices. Between June and September 1999, over 100 businesses voluntarily signed the declaration. All the major business associations in the city, which have a combined membership of over 1,200 companies, have supported the declaration and have presented it to their memberships for signature. By adopting the declaration, each company takes a no-bribery pledge, and must implement a code of business ethics.

After a decade of rent-seeking capitalism, Russians are beginning to accept the fact that government corruption is endemic, a historical burden on economic and political modernization. Russians are beginning to find their own path to root out corruption using a multitude of positive values and ethical traditions found in Russian culture. The St. Petersburg Declaration of Integrity is one example of a process whereby Russians are creating social capital by integrating their strong moral traditions with international standards of business ethics.

Faced with the evidence of endemic corruption in Russia, many in the United States are shouting, "let's call the game," as though punishing or sanctioning this powerful nation will enable it to throw off a complex history, as though many other nations are not similarly infected by crony capitalism.

Instead, we should recognize that the process of rooting out corruption is long-term, and that Russians must find their own path toward this objective. Under these circumstances it would be a mistake to isolate further the Russian people by depriving them of U.S. support and know-how and moral leadership. On the contrary, the United States should seize upon the evidence of endemic cor-

ruption in government to increase aid directly to small business and microenterprises and the nongovernmental organizations and business associations which are needed to lobby their interests. In the process, the U.S. can help Russian citizens prosper and form the social capital needed to protect individual private property from rent-seeking capitalists.

Thank you very much.

Mr. BEREUTER. Thank you, Mr. Murray.

[The prepared statement of Mr. Murray appears in the appendix.]

Mr. BEREUTER. Next, we would like to hear from Mr. Konstantin Borovoi, who is able to join us today. He is a member of Russia's parliament, the Duma, to which he won election in 1995. He holds a degree from the Mechanical Mathematical Faculty of Moscow State University, and began a career in business as the former Soviet Union began to allow the creation of some private businesses in the late 1980's. In 1992, he established the Economic Freedom Party.

Welcome, Mr. Borovoi. We look forward to your testimony.

**STATEMENT OF KONSTANTIN BOROVOI, DEPUTY, RUSSIAN  
STATE DUMA, CHAIRMAN, ECONOMIC FREEDOM PARTY**

[The following testimony was presented with the assistance of an interpreter.]

Mr. BOROVOI. Thank you, Mr. Chairman, for giving me an opportunity to speak to you.

It is actually one of the problems and one of the issues I work on in Moscow, the problem of criminalization of political power and the economy, and it is actually the main motive of my statements in Moscow, my press conferences and legislative requests that I make.

I would like to touch on a few issues that I think are important for me to make a point of here. Corruption in Russia is a part of a more complex problem, the problem of loss of direction of democratization in our country. What we call uncontrollable growth and expansion of corruption is more characteristic of what we had in 1995 and 1996. Today, we have a new phase of growth of corruption, where corruption now is an integral part of the government. At the same time, this current status of corruption is very convenient for the current rulers of Russia, and they are very happy with it.

Today's corruption and criminalization of power structures in government in Russia is influencing not only its domestic and economic policy but also its international foreign policy. The testimony of this process is the current events in the Caucasus and Chechnya, as well as the position of animosity toward NATO, toward the United States, and as well as a number of other initiatives taken on the international arena and also the support for the different rogue regimes in different parts of the world.

In 1991, good conditions were created for the forms of democratic Russia, but not all the government and economic structures were abolished, and it was clear for us already in 1992 when we met with the American policymakers and explained to them these negative trends and dangers in Russia. Actually, at a place not far from

here at the State Department I was attempting to convince the officials there that there is a danger of uncontrollable development of corruption in Russia, as well as serious threat to development of democratic principles. But they actually accepted a concept of self-propelled, independent process of democratization of Russia, and this process created a paradoxical situation in Russia and a paradoxical situation in the relations between Russia and the United States.

As a matter of fact, American taxpayers are financing projects that are implemented in Cuba, Iraq, Iran, and in Belgrade; and, as a matter of fact, right now Russia is not a friendly country toward the United States.

As a matter of fact, the American taxpayers' money is now spent on organizing of anti-American, anti-NATO propagandist campaigns. As a result of this anti-American propaganda campaign led by the Russian government, almost 85 percent of the Russian population was willing to support sending Russian volunteers and weapons systems, even advanced anti-aircraft missile systems, to Milosevic.

Unfortunately, humanitarian and even food product assistance for Russia is also a matter of increased corruption in Russia, and I think that the following steps are necessary in order to stop the development of this dangerous situation:

First of all, we need to say good-bye to the illusions about democratic development of Russia. Right now the only direction of development I see in Russia is the development toward forming of a small evil empire, adversarial to the rest of the democratic world; and I think in order to understand the process we need to have good professional expertise.

Unfortunately, here in the United States I frequently encounter very naive views on the situation and process that is happening in Russia. I think that all the programs of support, including the financial support and cooperation progresses, should be halted or stopped, and there should be a coordination between this type of assistance and the political process. Otherwise, the United States can find itself in the situation as it evolved when it will closely resemble what was happening in the events preceding to the tragedy at Pearl Harbor.

Also, I think it is important not to lose the hold of the pulse of Russia. I think it is necessary to keep and expand the forms of work that promote further democratization of Russia.

Thank you.

Mr. BEREUTER. Deputy Borovoi, thank you very much for your testimony and for the disturbing information that you give to us. We are very pleased, however, that you took the time to participate with this panel.

[The prepared statement of Mr. Borovoi appears in the appendix.]

[The prepared statement of Professor Lynn Nelson appears in the appendix.]

Mr. BEREUTER. We will now move to the question period under the Committee's 5-minute rule.

I will begin by mentioning that, in the course of the comments from Mr. Murray, I heard a degree of optimism—selective, of

course—and, at any time, I would like any of you to comment upon his orientation and his comments.

I would like to focus in, Mr. Palmer, on you first. Any other persons are welcome to make a contribution as well.

We have heard comments in the past—perhaps other Members of the Committee will pursue this—that U.S. policymakers were discouraged from presenting information which suggested the various U.S. programs were being subjected to corruption; and, in fact, information, therefore, was suppressed. Have you seen any evidence of corruption during the course of your time as a U.S. official, or after that point?

Mr. PALMER. I can only say that I cannot really discuss my time when I worked for the CIA. I think the fact that I took retirement from what had been a very rewarding career and went on to devote 2½ years of my life to studying this onsite shows that I believed that there was much more that could be done in looking at the problem.

I do know, from some of the programs I saw after retirement, that U.S. officials were constantly told that they had to show progress, that negative comments would only reflect poorly upon the U.S. facilities involved, and that they would only serve to restrain democracy. And so that was a general thread.

Mr. BEREUTER. How did you pick up that kind of sentiment?

Mr. PALMER. Simply in talking to some of the U.S. officials also involved in USAID projects after I retired, and these were just personal comments that they made to me, that they had gotten the word from the country team meetings that there was only room for good news.

Mr. BEREUTER. Would you encourage us to ask you to come to an executive session or is that—

Mr. PALMER. That could become problematic, actually, sir. But you do have some very good witnesses from State Department officers, Mr. Wayne Merry and Mr. Tom Graham, who both can speak to that with no legal difficulties, and they can speak in open session. I think you might find it more useful.

Mr. BEREUTER. The former has spoken to one of our Committees. I have forgotten which Committee that I heard him on.

The Duma was removed in 1993 by President Yeltsin. Some would say that he substantially reduced the Duma's authority to conduct oversight on the revenues and expenditures of the Russian government, and I would like to ask the Americans here as well as the Russian Duma delegate if, in fact, they believe that today the Russian parliament is in a position to reassert its oversight over the government budget. That would be my last question. I would like to ask any of the gentlemen if they would care to respond, and then I would turn to the Deputy.

Mr. PALMER. If I could just say one thing, and you have more expertise sitting here than myself, but the Duma is riddled with corruption to the point that organized crime members are now running for the Duma. Frequently, members of organized crime will pay Duma members large amounts of money so they can be named as staff members for the Duma so they can't be stopped by the police and they can't be searched for weapons.

That said, there are honest members of the Duma, and I think we have to encourage that, and we have to work with them. Trying to focus all of our attention only on the presidency of the country is, I think, going in the wrong direction. That is putting all of our eggs in one basket.

Mr. BEREUTER. Thank you. We hear that frequently, and we have an advocate in the person of Mr. Weldon of Pennsylvania.

Who would like to comment on the Duma's ability to conduct oversight on government affairs? Deputy Borovoi?

Mr. BOROVoi. I absolutely agree with the statement of the gentleman that corruption is an integral element in the work of the Russian parliament. Actually, I had one press conference on the illegal way of lobbying in the Russian parliament, and the theme of this press conference was the state Duma as a private joint stock company. The issues of corruption were raised at the sessions of the joint Duma-Congress commission; and, unfortunately, the majority of the Russian members of the parliament took the formal position that these allegations have nothing to do with reality. It is just the allegation and pretext for some accusation.

I don't think that cooperation with the Russian parliament can be an effective or efficient tool in fighting corruption in Russia.

Chairman GILMAN. [presiding.] Mr. Sherman?

Mr. SHERMAN. Thank you, Mr. Chairman.

One preliminary comment, and Mr. Bereuter's comment brought this up. I am disturbed that it is difficult for this Committee to get testimony in executive session from CIA agents and former CIA agents, and that while we are concerned about the transparency and honesty of the Russian government here in these hearings we should never spare effort to assure the honesty of the U.S. Government. Perhaps whatever we could do to get clear and honest executive session testimony from former CIA agents would be a step in that direction.

Deputy Borovoi, it is indeed shocking to hear your comments. I wouldn't be shocked if any of these other gentlemen said them, but you are an official of the Russian government and even the Chairman of a party. How many seats in the Duma does your party have, and do you think that your comments reflect the views of a few other parties in the Duma as well?

Mr. BOROVoi. My party has two seats in the Duma. Fifty percent of the state Duma members are communists. For you to better understand the balance of forces in the state Duma, I can give you the results of the vote on the resolution of support, political and military support, of President Milosevic that was taken in the Russian Duma—372 votes in favor, against 1.

Mr. SHERMAN. I understand. I don't know if the vote for Milosevic just reflects misplaced nationalism or whether it reflects corruption. I do know here in the United States we will get criticism for voting for aid for Russia or, frankly, for any foreign aid. I am convinced that at least half of what we send to Russia is wasted, and I am convinced that it is the most important thing we could possibly do with our dollars, to send aid to Russia, if even half of those dollars are used effectively, because I think the peace of the world depends upon many things which are easy to predict,



and one thing which we cannot predict, and that is the future of Russia.

Corruption is not unknown here in the United States, and we have adopted a number of laws, techniques, and procedures to try to control corruption. These are costly both in terms of dollars and in terms of flexibility. I wonder if the Deputy and perhaps some others could comment on whether Russia has studied, or even implemented American or Western European laws in the following areas: competitive bidding on outside contracts; independent audits of government agencies; civil service protection for the vast majority of government employees; a public documents act to require that any citizen can obtain a copy of public documents for only the copying charge; and, finally, an independent judiciary.

I realize that changing the law does not necessarily change culture, but it can be helpful, and I wonder whether there has been adequate attention in those areas.

I would like to hear from the Deputy first.

Mr. BOROVoi. Unfortunately, the entire theme of the fight against corruption is a political theme. I have a very simple example.

Mr. Stepashin was Prime Minister of Russia around 3 months ago, and now he is the head of the anticorruption commission. He talks of things during his Prime Minister activity, a lot of things that cannot be in Russian government now, any form of corruption. He is maybe the most active fighter against corruption. It is nonsense. Sometimes some vehicles, some discussions about corruption in Russia can be used for the purpose of corruption. I spoke before that it is an element, a structural element—corruption is a structural element of Russian power. It is maybe the most dangerous thing we faced since the beginning of democratization in Russia.

I have a lot of experience, European experience. We have some laws adopted now, but they are on the subject of political fighting against communists and democrats.

Mr. HENDERSON. A comment. I would say that all the laws that you mentioned are extremely important. In fact, I tried to highlight some of them in my written testimony.

In response to your question, only one of these laws to my knowledge exists and it exists by decree, not through legislation which, of course, is a large part of the problem in Russia. Many of the laws are issued by decree, and they are never implemented.

That really leads to my last and most important point. All of these laws are under consideration. I know that, for example, a Russian Freedom of Information Act law has been under debate for many years. There still seems to be no hope of passing it, according to people I know involved with it.

So the short answer really is that even if all of these laws were passed, none of them would be implemented in today's environment. There is no political will to implement any of these kinds of laws. I think that is a serious problem.

I did want to go back to one of the initial questions asked—in response to the question as to is there any evidence of the U.S. Government failing to correct problems and procedures that might lead to corruption. I think that might be the way I would ask the question. I would point to the HLID scandal as an example of a sit-

uation where I know that there was collusion within the U.S. Government not to properly oversee the way that very sensitive, important program was being implemented.

I talked to virtually everyone involved with that program during the time I was at AID because I was floored that there was very little government oversight, and I was finally told that that was intentional by people who know. And that, of course, is what led to the GAO investigation as requested by this Committee.

As far as the parliament is concerned, I am glad that issue was raised because the current Russian constitution, at least as seen by many analysts who have been studying this, Russian politics and the development of the law for many years, is fatally flawed. It gives the presidency too much power. The 1993 constitution really decapitated the role of parliament, and it is now not able to serve an effective monitoring function within the Russian government.

For more on this subject there are several new books that have just come out, one by Eugene Huskey at the University of Virginia, and another by Robert Charlotte at Union College. They are longtime Russia watchers, real legal scholars. One has been following developments in the presidency and the parliament for many years, and I would encourage anyone to read them who is interested in this subject.

Chairman GILMAN. Thank you, Mr. Sherman.

Dr. Cooksey.

DD. COOKSEY. Thank you, Mr. Chairman.

Mr. Palmer, I would like to direct these questions at you.

I had a friend that had done some work over there some years ago, and had gone back and forth, and it was something for the Russian people, not a business deal, just trying to help them out. But he reached the point that he said he was told that he would not be safe because he was not giving a portion of the goods that he was giving to these people, donated goods, to the Mafia people or whatever the underworld people were called.

How safe are Americans over there today in Moscow and St. Petersburg, or in the outlying areas like Ekaterinburg, for example?

Mr. PALMER. If we leave the Caucasus areas out of the obvious danger areas, and we talk about the major cities, largely, Americans are rather safe.

I recently did a study for a U.S. corporation on how much risk was involved in trying to collect debts from Russian firms even with direct organized crime ownership, which you would think would be one of the most dangerous things you could become involved in. What we found was that there really had not been a recorded case, at the time of the report, that any American had been killed or even injured because he tried to exercise his legal rights.

So far this year, there were, I think, four Americans who died. One was a T-shirt salesman. The only businessman was a used car salesman. I am saying it is not like any executives or anything of this because of their work.

The one case that everyone will point to is the case of Paul Tatum, who owned the Radisson Hotel and had the dispute with the city of Moscow, Mayor Luzhkov's office, one of the front runners for the next president. You can argue that he brought some of the difficulties on himself because he tried to imitate some of the

business techniques of organized crime. So it was danger to himself.

I suspect that there is normal street crime that you would have in a city like New York. Other than that, I have not seen any more serious risks to Americans.

Mr. COOKSEY. Good. That answers my question.

For several years there have been some allegations that some of the top people in the Russian military have been involved in some of the massive corruption and theft of the government funds, including Yeltsin's First Minister of Defense Grachev. There are also reports that a young reporter that was killed in October 1994—1998 was also linked to this type of corruption.

Do you have any views about these allegations that you can share with us in an open session? I mean, do you think that, in fact, people in the military are involved in this corruption and the killings?

Mr. PALMER. Graham Turbeville, who works at the National Defense College, wrote an excellent 50-page paper detailing the corruption in the military. It is widespread.

I cannot speak to the case of the journalist who was killed. There have been other journalists who were killed by nonmilitary. I would say that probably the stories are true.

What we do know, and I can tell you I know for a fact, is that almost every Russian soldier has to give a percentage of his salary to his commanding officer. It works its way up. They rarely ever get the rations they are supposed to. They frequently sell off weapons. I watched as the Russian army was pulling out of the former Soviet Union and they would come up and offer you AK-47s, grenades, and even anti-aircraft missiles offered to me after I retired. What I am saying is it is a very common thing.

The other thing I should tell you is that you will notice that Spetsnaz, the Russian special forces, which are involved in more assassination and sabotage than the type of our special forces are involved in, are reported very reliably to have started training Russian organized crime hit men about 3 years ago as a way to make extra money, and they are now one of the leading employers of ex-Spetsnaz people. That is why when they kill people they don't blow up city blocks, they are more likely to get the right guy. That is a leading indicator that, indeed, the military is corrupt.

Mr. COOKSEY. There is a Russian analyst named Glakena who reported that 13 percent of all the vouchers issued under the U.S.-financed privatization program in Russia ended up in the possession of one American firm. Do you know anything about this allegation, and do you believe that such accumulation of vouchers could have indeed been carried out by one American firm? Do you know who the firm is?

Mr. PALMER. I have read the same articles. I am familiar with the background on the firm. I do not have direct knowledge of it. I do know that a Russian government study said that a minimum of 85 percent of all the privatization shares came into the possession of organized crime. Whether they would deal with an American firm, I would say that is not even a serious question. Of course they would. The American firm would not necessarily have to know, in a legal sense, that they were dealing with organized

crime, but that is the only way that you could control such a large amount of vouchers.

Mr. COOKSEY. Mr. Satter from Johns Hopkins, it is reported that a Russian tycoon, Vladimir Pontanin, sold an oil company called Sidanko for \$2 million in 1996, and later sold 10 percent to BP for \$570 million. It has also been reported that the Russian automobile company Vaz was sold at voucher privatization auction for an estimated \$45 million even though Fiat had offered \$2 billion for it in 1991. Do you feel that some of these industries have indeed been sold for less than what they are really valued at?

Mr. SATTER. Unquestionably. The examples that you cite are two among many of the way in which the most valuable enterprises in Russia were practically given away, and they were given away through a variety of means. One of them was the voucher privatization that we just talked about.

When I was living in Moscow in late 1992 and early 1993, voucher privatization was at its height. At every metro station and at many bus stops, there were people with signs reading, "I will buy a voucher." These persons bought vouchers for a few U.S. dollars or for a bottle of vodka from alcoholics and other persons who didn't know what the vouchers potentially meant. Then the vouchers were used to purchase enterprises at fire sale prices.

Another reason why this was possible was because once the voucher privatization had ended and money privatization began, the auctions at which enterprises were sold were rigged. The victor in the auction was determined in advance. In some cases there never was an auction. It took place only on paper. In situations where an auction was held, if someone was brave enough to bid against the pre-determined winner, he was putting his life in danger. This is the reason for those low prices.

Mr. COOKSEY. I will give you my opinion. I assume there is someone here from the Russian Embassy. You can send this message back from the Fifth Congressional District in Louisiana. I was in the military 30 years and a month ago. We have people in my district and districts across the United States that are paying taxes. I still have confidence in the goodness of a lot of the Russian people, but we do not want to pay taxes to this government, to our government, our own government and then have it given to the Russian people and squandered or taken by outright theft.

Yesterday, in a hearing on this same subject, we were advised that approximately \$200 billion has been spirited out of Russia in the last several years. I am sure some of that was American taxpayer dollars and, if we had that, we could have balanced the budget and been home 2 weeks ago. That is a concern that I have no matter what my district is.

My concern about this Administration, if there is anyone here from the State Department, is that at times you get the feeling that there is—well, to their credit, I think some people in the State Department are stronger than the people over in their boss's office—but they just want to try to make everybody feel good. If they go have a meeting and drink a little vodka, we will give them everything and throw in the kitchen sink. But still, that is American taxpayers' dollars, and we just don't want to continue doing that. That is my personal opinion.

Mr. SATTER. I just want to make one observation. The Russians are very smart people and do not need to be taught by the United States how to invent the wheel. The problem with the truthful revelations about corruption in Russia is that they may turn public opinion against any aid for Russia, and Russia right now is in a desperate situation.

While I was completing a book that I wrote about the fall of the Soviet Union, I did a little bit of work for Reader's Digest. One of the articles I had to write was about kids who die in Russia because they don't get timely heart surgery. They have defects that are easily correctable over here. The reason these children are not operated on is that, although there are talented surgeons in Russia, Russian hospitals don't have the necessary equipment.

If we had only had the wit at the beginning of this process to orient our aid toward genuine humanitarian needs in Russia and not toward teaching the Russians how to be capitalists—a process which enriched our own consultants and led us to cooperate with a lot of people who spoke English very well and made a good impression on us but turned out to be totally corrupt—we could have done some good there.

In the reaction now to what we did do and what, of course, the Russians did for themselves—I mean, after all they are adults—we may turn against the idea of helping Russians in any way, even in those situations where we can help and where our help is badly needed.

Mr. COOKSEY. There is no question that we could reach that point, and I think that is unfortunate. I am a surgeon, and there are some similar talented, bright people in Russia, good physicians, good surgeons.

Anyway, it gets back to the same problem that is a problem the world over. Sometimes you don't always have the best and the brightest in government. There are a lot of bright, capable people, particularly the Chairman and myself. I am being facetious. He is, for sure. But then you get people that just don't do the right thing, and it is a problem. It is a problem in Russia, and I hope that they can evolve to an era where they will have more integrity and do the right thing for their people instead of for themselves.

Mr. PALMER. Briefly, but it supports some of your earlier comments, the Russian Ministry of Interior did a study and, as of the end of 1998, from 1991 to today they estimated that total theft out of Russia had been over \$300 billion, and Interpol agreed with those figures. That may be a low figure.

Chairman GILMAN. Is that with a "B," billion?

Mr. PALMER. That is with a B, billion, sir.

Mr. COOKSEY. So that is \$100 billion more than we were told yesterday.

Mr. PALMER. Those are Russian Ministry of Interior figures, and Interpol supported them. Other estimates run higher.

The argument is made, well, there were not that many dollars in Russia. I would make two comments. This also includes Russian resources that go out at low prices for high profit on the outside. And, second, I would remind you that, through 1996, we had weekly planes going to Russia, 747 cargo aircraft carrying \$100 dollar

bills. At one time, Russia had more U.S. \$100 bills in circulation than the United States.

Mr. COOKSEY. I have heard that. Is that a correct statement?

Mr. PALMER. That is correct, and one could assume that those dollars didn't stay in Russia. That is the loss.

But in 1998, prior to that last IMF tranche going to Russia, I was at a discussion group here in Washington and we were talking to the Russian desk officer and some of the administrators, and we said why are we sending this money? It will disappear. And they said absolutely not. Corruption has really been beaten. On top of that, they have a new tax collector and he is going to increase tax collections. So, actually, in 2 years time they will have a surplus.

Well, everyone there had a laugh about that, but there was no stopping the money. It was going to go. That money went and is gone, and now we are going to replace it. The point is this: The taxes that they do not collect are being made up by money that comes from the U.S. taxpayers. They are stealing that, moving it out for personal gain. We are making up the difference. I think something is wrong with that picture, and I think the average American taxpayer will see it that way too.

On the other hand, Mr. Satter said, we cannot shut everything off in our dealing with them, but we have to have more control. It has not come from the Administration thus far. I think it has to come from Congress.

Thank you, sir.

Mr. COOKSEY. One question for Mr. Borovoi. It has been alleged that Russia's Chief Prosecutor, Yuri Skurotov, that the Yeltsin administration had tried to remove from that position, that the government recently brought the investigation in connection between the Kremlin and the Mabetex Construction Company in Switzerland. Is this true? This was in the paper about 60 days ago. I remember seeing it, that there was an allegation that there was a connection between perhaps Yeltsin's entourage and the Mabetex Construction Company that had paid some of his credit card bills. Is that true? Have you heard about that? Are you familiar with that?

Mr. BOROVoi. I am familiar with this situation. I have no doubt that Pavel Borodin profited from construction and restoration work contracts in Moscow.

But I would like to go back to the problem that I have pointed out about the competent professional expertise about the situation in Moscow.

The resignation of the chief prosecutor—general prosecutor happened when Mr. Primakov was Prime Minister in Russia. As a matter of fact, that event was the result of a fight between the entourage of Mr. Primakov, which we call the KGB group, with the entourage of Mr. Yeltsin. The process is much more complicated or complex than it is seen from here.

Dr. COOKSEY. Thank you.

Chairman GILMAN. Thank you, Dr. Cooksey.

I would like to address this question to all of our panelists. We all recognize that there is an extensive amount of corruption in Russia, but what do you recommend now? How should our policy

toward Russia change or be revised in order to address this worsening situation? And let me start with Mr. Palmer.

Mr. PALMER. Thank you, sir.

It seems to me the first thing we have to do is depersonalize the foreign policy. There are some quarters in this town that believe that our relationship with Russia depends on good contacts between a few officials on both sides. I think that has to be broadened. I think we have to deal with all aspects of the Russian political scene. That certainly includes the Duma. That means we cannot focus on only one group or one party. Everyone talks about this. I have seen no change in that.

Second, we cannot support one group blindly. Imagine from the American point of view if the Russians sent us 30 election experts to help run the 2000 elections and sent us several million dollars to help organize them. I don't think that we would take that well, no matter which candidate won, and that is precisely what we did with Russia. We sent experts. We sent money. I don't think we can do that. I think we have to stand back a little farther from that. We cannot take sides quite so often.

The next thing I think we have to do is make every bit of the not only aid, but loan money, a quid pro quo. That means, yes, we will support investments in Russia after you have come up with a bilateral U.S.-Russian investment treaty. This is a normal thing between states. If we are going to encourage investment, let's protect our investors. I think that is not only prudent, I think it is responsible.

I think that we should have audits. If we look at the food aid that has just gone to Russia, that food aid was meant to disappear. Marcy Kaptur argued constantly for more controls on that. They didn't happen.

I looked into this with the Department of Agriculture, and they said, well, we are thinking about things, but when we hear something that we like we will let you know. That is not how the government sets the pace. They paid the contractor to come up with the idea of let's distribute information about food delivery on the Internet so that people could track them. The people that we are concerned about don't have enough money to eat. I am sure they don't have computers at home and Internet. They do not have power. Let's be realistic in these things.

This food aid is an example. We purposely said we don't want to audit it. Right now we are completely dependent on the Russians bringing us once a week statements that this food was delivered. I know for a fact some of these statements of food being delivered were signed in February and March although the first shipments didn't arrive until May.

What I am saying is, let's take a reasonable bipartisan look at this and try and do this government to government like we would anywhere else.

Thank you very much.

Chairman GILMAN. Thank you.

Mr. Henderson, would you comment?

Mr. HENDERSON. Sure. I concur with Mr. Palmer's comments but would say that one of the most important issues facing the global community is the security of the world's financial system. I think

the Bank of New York case, again, only begins to illustrate that this is a very serious problem for not only the United States, but for the international community. I know there are separation hearings under way on that matter, and there are a lot of discussions that need to be held.

But on that point, I think whether you are talking about the banks, private banks, or the World Bank, or the IMF, or USAID, or even corporations, private corporations, much more emphasis needs to be placed on know your customer rules and know your employee rules and when is an employee obligated to report on suspicious, corrupt transactions? Until this culture of silence is broken within the corporate community and within the multilateral donor community and at other donor agencies around the world, I think you are going to see very little progress on any of these fronts. Right now, no one is really reporting on corrupt, suspicious transactions. It is questionable how well written the bank's rules and regulations are in this regard—that is private banks. So this is a very serious issue that must be addressed very promptly.

I think, again, the other thing that we could do, as Mr. Palmer was mentioning, is to get our own house in order. We who have been studying the corruption problem for some time see an awful lot of corporate complicity in the corruption process. Everyone knows that it takes two to tango, and it doesn't appear as though the laws that we have on the books, not only the U.S. but in other countries, are properly being enforced. The OECD antibribery treaty is going to have little meaning unless we find ways to enhance the way that it is implemented.

The last and maybe most important point in my mind is that you hear a lot of rhetoric now about the need to work more with civil society and small business associations and the private sector. This is the kind of conversation going on now within the World Bank and within other donor agencies, including AID. But the reality is that most of these institutions don't have the mechanisms or policies in place to begin to work with civil society. Until civil society becomes more involved in corruption oversight, if you will, and providing a real check on governmental action, again, I think you will see little progress on this front.

Chairman GILMAN. Thank you, Mr. Henderson.

Mr. Satter?

Mr. SATTER. Policy must be based on principles, not personalities. Russia is a country which has suffered a 70 year assault against its moral sensibility. Therefore, what the country needs and what it is often incapable of generating internally is an appreciation of right and wrong and a sense of fidelity to law.

If we enter the Russian situation and, irrespective of the morality of its actions, back the political faction that we consider to be progressive, we actually further undermine the moral fabric of society. We did this many times. We did it over the war in Chechnya. We did it at the time of the forcible dispersal of the Russian parliament in 1993. We continue to do it when we close our eyes to the corruption in Russia and the way in which organized crime is terrorizing the ordinary Russian citizen.

Russians were inculcated for 70 years with the idea that capitalism and criminality are more or less the same thing. Now they



are living in a state which is largely run by criminals to whom we give our rhetorical support. Therefore, we confirm them in their previous prejudices.

The first thing we have to do is sever the link in the minds of the Russian people between capitalism and crime, and to do that, we need to insist on fidelity to law and fidelity to ordinary moral principles and stop making excuses for the people that we describe as "progressive" and who, in fact, are not progressive.

To implement this idea further, there are a couple of concrete steps that we can take. First of all, we should take care with our rhetoric. We should not say that President Yeltsin, when he is authorizing the carpet bombing of civilian areas in Chechnya, is comparable to President Lincoln defending the American union. We should not endorse the forcible and illegal dispersion of the Russian parliament. We also should not try to interfere in the Russian elections.

But, beyond this, we can make it clear that people who have obvious ties to organized crime figures are not welcome in the United States and that the organized crime figures also are not welcome here. Since these two categories include many of the leading people in government, such action will have psychological significance both for the government and for the Russian population.

In general, rhetorically and with our influence over international loans we need to, in every concrete situation, back crime-fighting techniques, back institutions which will be resistant to crime and end the previous tolerance that we have shown over the last 7 years for those people who believe an economy is organized stealing and behave accordingly.

Chairman GILMAN. Thank you, Mr. Satter.

Mr. Murray?

Mr. MURRAY. Yes, Chairman Gilman.

In my view the best way to both combat corruption and otherwise sustain market reform in Russia is to reduce the barriers to small business. To date, this has not happened. As I indicated in my earlier testimony, in fact, the barriers to small businesses have increased over the last 10 years due to rent-seeking behavior on the part of the government.

If barriers to small business are reduced, we will see the creative business potential of the Russian people unleashed for the first time. We haven't witnessed that yet. Small businessmen have not been allowed to create wealth and to create a middle-class without being extorted or preyed upon by the tax authorities.

The best way to help them do this is not by simply throwing money at Russia, of course, but rather by helping the emerging small business community create what is called "social capital" which is to say the values and the mores that are needed to run businesses honestly.

Earlier, Congressman Bereuter commented that I sounded very optimistic and that it was unusual. The reason I am optimistic is that, to date, business and moral aspirations have been kept in quite separate categories during this reform period in Russia. They are treated as being two separate endeavors. In this project we have conducted on behalf of the Eurasia Foundation to create the Declaration of Integrity in St. Petersburg, we have found that

when moral aspirations and business are combined, there is a new level of enthusiasm and determination to conduct business on the part of the average citizen. I believe that once the barriers to small business are broken down you will see people with the profit motive take care of this corruption problem efficiently, more efficiently than it has been addressed to date.

Chairman GILMAN. Thank you, Mr. Murray.

Mr. Borovoi.

Mr. BOROVoi. First of all, it seems dangerous to me, the trend of stepping back from involvement in the political process in Russia or being bystanders and just observing what is going on. If this point of view was prevalent in 1948, then 70 percent of German parliament would consist of Nazis. I think that the major highlights of democratization of Russia are programs targeted for development of education and democratization. I think that the \$600 million that was spent on the procurement of food products would much better be spent on purchasing mass media and providing programs for education and enlightenment of the Russian population on economics and democracy, free market economy.

Chairman GILMAN. Thank you.

Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman.

I would like a member of our staff to give this to Mr. Henderson if you could, kindly. I am telling you what this is.

At yesterday's hearings on the same subject, Dr. Michael Waller, Vice President of the American Foreign Policy Council testified. He put into the record this e-mail—and I am going to read to you what he said about it—you were in the e-mail, but I am going to take a second and explain it.

The suggestion is that the principal contractor for USAID for the rule of law project, ARD-Checchi—and I am quoting from Mr. Waller's testimony—tried to suppress a noted expert in Russian crime and corruption from voicing concerns about the USAID-sponsored privatization program. That expert, Professor Louise Shelley of the American University, and a colleague of Dr. Waller's at Demokratizatsiya journal, had early evidence that organized criminal elements had exploited the U.S.-backed privatization program.

In June, 1994, ARD-Checchi rule of law project director David Bronheim sent an e-mail notice to offices in Moscow, Kiev and elsewhere with a warning about Dr. Shelley that appears to be intended to suppress and discredit her, and he then quotes the e-mail, a copy of which I have given to Mr. Henderson.

"Professor Shelley. Please treat this with enormous care. If I had known what Shelley was up to I would have resisted Henderson's instruction to put her on the consulting contract. She is a bomb with a lit fuse. Her hobby horse is that the AID privatization program has been exploited by organized crime.

"The privatization program is the showpiece, the flagship, et cetera, of the AID program in Russia. Shelley, without understanding what she is doing, is trying to sink the flagship. Under no circumstances can we be seen as helping that effort. We have no interest whatsoever in damaging the centerpiece of the AID program in Russia." end quote of the e-mail.

I continue with Dr. Waller's testimony: "there you have it, as frank an admission as possible that experts concerned with corruption of U.S. assistance programs were simply not welcome. A copy of the e-mail is attached."

That copy is what I have just supplied to Mr. Henderson.

[The information referred to appears in the appendix.]

Mr. CAMPBELL. As you might guess, I am interested—knowing that you were on the witness list today, I brought this—I am interested in your advice to us as to whether, much more importantly AID, but not trivially, whether a contractor of AID actually tried to suppress an expert as was described by Dr. Waller in his testimony.

Mr. HENDERSON. Thank you. I am familiar with this situation, and I would provide by way of background a note that this memo was written in response to internal memos at AID by some in the privatization office. They were concerned that Professor Shelley, as well as myself, were beginning to raise some questions about their privatization program. David Bronheim, who is a brilliant analyst, a former AID employee, and he is now deceased—he was actually killed in a car wreck in Georgia working on an AID program—was, I think, mainly trying to respond to this concern within the privatization office at AID that its centerpiece program was going to be called into question by folks. They were not at all happy with the fact that people like myself and the democracy and governance office were giving her the opportunity to, at least, express her opinion.

I did not know at the time, to be honest with you, whether the information she was provided was completely accurate or not, but I felt like, as did some others at AID, that this was an issue that needed to be openly discussed, and encouraged her to provide testimony to Congress when called to do so.

I guess the good news is that she was retained for a limited amount of time, even after this occurred, that the contractor's opinion had no impact on her employment or her ability to speak out on this issue. But this memo and in particular, the memos that I saw that were circulated by people in the privatization office were of great concern to me because they were clearly trying to stifle any discussion of this issue.

Mr. CAMPBELL. Then let me ask the most important question, to me at least; and I am going to put it in a way that sounds leading, but you are an intelligent person, able to address it, so don't say anything you wouldn't otherwise. But I take your testimony to be that, to the best of your knowledge, USAID did not attempt to suppress research indicating corruption of the privatization program; is that correct?

Mr. HENDERSON. I was trying to say that some employees within AID were, in fact, trying to suppress research and open discussion on this issue. I am referring to discussion that occurred at the programmatic level. I know of no intervention on the part of high-level AID or State Department employees. These were people operating more at a senior programmatic implementation level.

Mr. CAMPBELL. Thank you.

I have one last question for Deputy Borovoi. I would like to ask what the prospects are for the Economic Freedom Party and other

members of the Duma who believe, as you do, in the upcoming elections?

Mr. BOROVoi. Unfortunately, Russian politics today is dominated by nationalistic and isolationist forces. In the current composition of the Duma there are about 50 percent of these forces. I think that after the next election there will be about 80 percent of them. This is the result of a very powerful, mighty antiwestern campaign that was modeled after Soviet-style propaganda campaigns trying to picture western community as an enemy. The examples of these campaigns, there was a campaign of support for Iraq and a campaign of support of Milosevic and a campaign against NATO expansion. So, if this trend is going to continue, I don't think there are any prospects of any democratically inclined parties in Russia.

Chairman GILMAN. I think we have overstayed the patience of our experts. We want to thank our witnesses for their participation in the hearing today. I am certain that your thoughts and your comments will assist the Members of our Committee as we seek to better understand developments in Russia today and as we make recommendations for the direction of U.S. policy toward that important country in the future.

This hearing of the Committee on International Relations is now adjourned.

[Whereupon, at 12:25 p.m., the Committee was adjourned.]

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## **A P P E N D I X**

**OCTOBER 7, 1999**

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# NEWS



## International Relations Committee

U.S. House of Representatives \* Benjamin A. Gilman, Chairman \* 2170 RHOB \* Washington, D.C. 20515

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### GILMAN ON RUSSIAN CORRUPTION: "I SUSPECT IT GOES TO THE TOP"

WASHINGTON (October 7) — U.S. Rep. Benjamin A. Gilman (20<sup>th</sup>-NY), Chairman of the House International Relations Committee, released the following statement from today's committee hearing on "U.S. Policy Toward Russia, Part II: Corruption in the Russian Government":

"I have no doubt that the corruption within the Yeltsin government in Russia is extensive. Our hearing this morning will seek to assess just how widespread the corruption is — and just how high it does go. I suspect that it goes to the top of the Russian government. I will cite just a few cases and reports that have led me to this conclusion.

"The Swiss investigation into financial links between the top Kremlin staff and members of President Yeltsin's family and a little-known Swiss company called Mabetex.

"The Swiss investigation into the links between the Russian airline Aeroflot — whose Vice President is President Yeltsin's son-in-law — and Swiss companies set up by Russian tycoon Boris Berezovsky to which Aeroflot's hard currency revenues have been diverted.

"A decree issued by Mr. Yeltsin in the early 1990s granting a Sports Foundation set up by a close friend an exemption from export and import taxes that in turn allowed that 'foundation' to retain an estimated \$4 billion or more that would otherwise have gone to the government in tax revenues.

"As reported in a comprehensive review by U.S. News and World Report magazine — an investigation begun by the FBI in 1994 into the activities of a company called Golden A.D.A., set up by a top official and close associate of President Yeltsin's in San Francisco.

"After its establishment, that company shipped tens of millions of dollars of diamonds, gold and antiquities out of the so-called Kremlin vaults and sold them, with the money allegedly disappearing into high-priced real estate and foreign bank accounts.

"The 1996 arrest of a top aide in Yeltsin's re-election campaign who was caught leaving the Russian 'Government House' in the company of a reputed Moscow mafia figure and holding a half million dollars in cash in a briefcase — a arrest that never resulted in any prosecution.

"And then the notorious 'loans for shares' privatization program of 1995 and 1996, under which the crown jewels of Russia's oil and metals companies — such as Sidanko and Norilsk Nickel — were sold to Russia's new tycoons for a mere pittance.

"Then there were allegations linking a former Yeltsin government representative at the International Monetary Fund to the on-going investigation into the possible laundering of billions of dollars in Russian monies through the Bank of New York.

"Use by the Russian Central Bank's top officials of an off-shore company — FIMACO — for financial purposes that may yet not be fully understood.

"Then the alleged massive corruption in the Russian military that cost the lives of, first, a young reporter, and second, a Member of the Russian parliament, both of whom sought to bring that corruption to light.

"I should note that this is by no means a full or comprehensive list.

"But let me turn to another question we should be considering. At a hearing this Committee held yesterday, one of our witnesses, a former analyst for our intelligence community, stated his suspicion that there may be American partners having some self-interest to ensure that IMF monies continue to flow to Russia as Russian monies are siphoned out of its government and economy and into Western banks and accounts.

"That suspicion is something we need to look at with great concern. As our Members may know, our Department of Justice is now investigating allegations that personnel of a top AID contractor in Russia — the managers and overseers of our US-financed privatization program in that nation — engaged in personal investment activities while carrying out their work for our government in Russia.

"In 1996, before that Justice Department investigation began, I commissioned an investigation by our United States General Accounting Office into the work of those managers in Russia out of concern that the Administration had channeled \$40 million in non-competitive grants to them.

"As the Justice investigation was beginning, we asked the GAO to look into the activities in a key subgroup of the Gore-Chernomyrdin Commission of one of those allegedly under investigation by AID and Justice. At the request of the Justice Department, we later suspended that GAO investigation.

"I now note, however, that press reports have alleged that another American under investigation in this matter by Justice has been named in a law suit that alleges that a pricing conspiracy was organized to siphon off millions of dollars from a Russian company into off-shore accounts.

"I mention this matter today because I believe that we should be interested and willing to learn whether we have not just a Russian corruption problem — but whether, in fact, we may have something of an American problem as well.

"As one Russian analyst has stated, it is interesting that one American firm managed to obtain over 10% of the vouchers that were issued under the Russian privatization programs set up with American assistance in the early 1990s. The question is how such things came to pass."

*Witnesses at the hearing included: Mr. Richard Palmer, President, Cachet International, Inc., U.S. Central Intelligence Agency, Retired; Mr. Keith Henderson, Former Senior Adviser on Rule of Law, Crime, and Corruption, U.S. Agency for International Development, Co-Director, Trans-National Crime and Corruption Center, American University; Mr. David Satter, Visiting Scholar, Johns Hopkins School for Advanced International Studies, Senior Fellow, The Hudson Institute; The Honorable Konstantin Borovoi, Deputy, Russian State Duma, Chairman, Economic Freedom Party; and Mr. Matthew Murray, President, Sovereign Ventures, Inc.*

U.S. House of Representatives  
 Committee on International Relations  
 October 7, 1999  
 Hearing on Corruption in the Russian Government  
 Richard L. Palmer  
 Cachet International, Inc.

Mr. Chairman and Members of the Committee, it is an honor to be asked to testify today on this important subject.

As was the case in my testimony before the House Banking and Financial Services Committee on September 21, 1999, I will once again attempt to provide even more documentation to prove that there has long been publicly available, detailed information concerning the level and dimensions of corruption in the Russian government and business sector. Further, I will also show that this information was already easily available as early as 1994 through 1996.

The problems of official corruption, organized crime and powerful extra-governmental structures in Russia have long been the subject of readily available public media reports and academic studies – as well as one hopes more detailed US government studies and reporting. Since at least 1992, it has been widely recognized that there is widespread official corruption in the former USSR; that organized crime groups have corrupted many public officials and business people; large Financial Industrial Groups (FIG's) are apparently above the law; and, that former officers of the KGB are frequently involved in dubious businesses, sometimes with ties to organized crime. It is this new "oligarchy" that holds power in Russia today. In spite of all of the various studies that have been done, the actual development of this oligarchy and its participants is not well understood. Worse yet, the fact that these elements controlled the majority of the Russian government and business enterprises was ignored.

In fact, the power and wealth in the Russian government as well as some of the governments of the former republics have been taken over by former members of the "nomenklatura" and other bureaucrats, Party leaders, KGB officers and organized crime groups. They continue to increase their control, wealth and influence not only in these countries, but in the West as well. This was the result of a deliberate program by the former top members of the Communist Party to maintain their power, wealth and privileges. Concurrently, the influence of the Mafiya became even greater during this process. This conglomerate, the "new Russian oligarchy", is made up of a loose coalition of the former nomenklatura, KGB officers, Military Industrial Complex (MIC) and Russian organized crime groups. The oligarchy was successful in gaining a near monopoly on the funds, property and power of the former Soviet State. It continues to hold a virtual monopoly on key Russian resources controlling enormous material and financial wealth. The oligarchy has vast political power and uses both the Russian bureaucracy and weak legal system to inhibit the emergence of a genuinely "free market" and the growth of "capitalism". This presents clear dangers to Western countries. There



is convincing evidence that it was not a matter of these criminal groups corrupting the Russian nomenklatura and infrastructure, but rather that nomenklatura utilized the criminal groups and KGB to retain a measure of their power, wealth and leverage over property and raw material resources following the dissolution of the USSR and its command-administrative system. Further, the term "organized crime" is equally applicable to the structures of the former nomenklatura as it is to the Russian Mafiya. Actually, the nomenklatura make up about 85 % of what is known as "organized crime" in Russia and only about 15 % consists of the criminal groups commonly known as Mafiya. Finally, all of these structures have increasingly influence and direct authority in the current Russian government as well as internationally.

In testimony before the US Congress in 1994, then CIA Director James Woolsey summed up this relationship as follows: "Organized crime is not a new phenomenon in Russia or Soviet history. During the Soviet era, criminal groups and the black market often functioned as an extension of the Communist party and the KGB. In fact, the Communist party and KGB used criminal groups and the black market as a second, parallel economy to further their own goals and enrich their own organizations. They had their own codes, traditions, and loyalties.....In the late 1980's, we saw strong indications that state control had begun to wane. Many of these criminal organizations outlived the state which fostered them and took on a life of their own. This 'old guard,' however, has been severely challenged by a surge of upstarts.....Since the breakup of the Soviet Union, we have seen a dramatic rise in new criminal groups that operate independently without regard for whatever ground rules for criminal activity that might have existed before. The 'new Mafia,' as it is often referred to, does not abide by the old customs established by the traditional Russian underworld."

In his June 1994 testimony before the US House of Representatives, former CIA Director James Woolsey stated that: "The Russian Ministry says there are roughly 5,700 organized crime groups in Russia, with an additional 1,000 in the other former republics. To keep this in perspective, I want to point out that many of these organizations are actually small, local groups of petty thieves. They would not fit the Western definition of organized crime. However, of the 5,700, approximately 200 are large, sophisticated criminal groups engaged in criminal activity throughout the former Soviet Union and in 29 other countries, including the United States...."

- A (then) recent report prepared by President Yeltsin's staff concluded that 70 to 80 percent of privatized enterprises and commercial banks have been victims of extortion [by organized crime...Russian criminal groups are actively involved in the illegal transport and sale of narcotics, antiques, icons, raw materials, stolen vehicles, illegal immigrants, weapons, and some nuclear materials....
- [T]hese groups have the resources with which to bribe nuclear weapons handlers or employees at facilities with weapons grade nuclear material. They also have established smuggling networks that could be used to move such material out of the former Soviet Union...Criminal groups are also targeting the financial sector where economic reforms have led to explosions in the number of banks, in the complexity of their transactions, and in the geographic scope of their activities. ..

- [T]hese banks have become a particular target for money-laundering schemes. Indeed, links have been forged between Russian and Italian organized crime groups to move money through the Russian banking system. In addition to taking advantage of these banks, organized crime groups have set up front companies throughout eastern Europe and Russia....
- The power of Russian organized crime is largely due to their ties to corrupt government officials....Criminal groups may be spending as much as 30 to 50 percent of their profits trying to buy off well-connected government officials, including Customs, militia, and police officials....
- The ramifications are enormous. For Russia itself there's a real threat that the surge in crime will sour the Russian people on President Yeltsin's reform program and drive them into the arms of Russia's hard-line political forces....Beyond the threat to Russian reform, the growth of organized crime could seriously affect our efforts worldwide to combat international crime."<sup>1</sup>

In October 1993, the Russian Ministry of Internal Affairs reported there were over 5,000 organized crime groups operating in Russia. These groups were comprised of an estimated 100,000 members with a leadership of 18,000. The report also stated that although the Russian authorities have currently identified over 5,000 criminal groups in that country, Russian officials believe that only approximately 300 of those have some identifiable structure.<sup>2</sup> Later reports from 1996 put this figure at over 150,000 full time personnel in Russia with over 150 senior "godfathers". As of July 1994, according to Russian MVD figures, there were "precisely" 5,691 criminal groups; 3,000 criminal leaders; 279 high level leaders; 920 groups united into 155 criminal associations.<sup>3</sup>

### **FINANCIAL RESOURCES**

In a December 1994 article in the Washington Times, which they claimed based upon a leaked secret CIA report, it was stated that "more than half of Russia's largest 25 banks, including one with an office in Washington, are linked to Russian organized crime." The report went on to state that "senior Moscow officials believe that Menatep (Bank) 'is controlled by one of the most powerful clans in Moscow' and has been involved in violating international trade sanctions." The alleged CIA report added that these Mafiya linked banks were involved in bribing state officials for advance information on exchange rates, which allowed for windfall profits for these banks. Further, the report noted that the Mafiya maintains informers in Russian banks to advise the criminals when certain clients accumulated certain amounts of funds so that the criminals could move against these clients and their firms.<sup>4</sup> (NOTE: Oddly enough, the Federal Reserve Bank was apparently unaware of this alleged report when they apparently accepted the reported recommendation of the Bank of New York – in the person of Vice President Natasha Gurfinkel Kagalovsky – that the Russian Inkombank be allowed to open an office in New York.

In 1994, former CIA Director James Woolsey added that "...Of the 2000 banks in Russia today, a majority are controlled by organized crime, according to the Ministry of Internal Affairs."<sup>5</sup> In August 1995 the MVD All Russia Scientific Research Institute estimated that criminal groups control over 400 banks and 47 exchanges. An even more pessimistic

assessment was made by Professor Lydia Kraslavina, head of the Institute for Banking and Financial Managers, who estimated that 70 to 80 per cent of private banks in Russia are controlled by organized crime.<sup>6</sup>

According to a 1994 report prepared for Boris Yeltsin by the Analytical Center for Social and Economic Policies, 75 percent of Russia's private enterprises pay 10 percent to 20 percent of what they earn to criminal organizations.<sup>7</sup> More recent estimates from 1996 and 1997 are 20 to 30 percent of the profits must now be paid to the Mafiya - with these costs being passed on to the consumers.

Some 40,000 state and privately run companies, including most of the country's banks, are controlled by 150 criminal syndicates.

Corruption among the police is rampant. Frequently, in Russia as well as former republics like Latvia, victims of car theft are referred by the police to organized crime groups who often will agree to return the vehicles in exchange for paying half its original purchase price. The police often offer to help the victims to contact the Mafiya. This kind of maneuver has become standard procedure, confirm other Russians.<sup>9</sup> Retired Russian police general Aleksandr Gurov noted what many Russians confide in private, in that the Russian Mafiya now acts in place of several state agencies, such as the police, court systems, etc., and it is to the Mafiya that many businessmen are forced to turn to obtain payment on contracts, received paid for goods, etc.<sup>10</sup>

FBI Director Louis Freeh stated before the US Congress that over 200 of Russia's 6,000-odd crime gangs operate with American counterparts in 17 U.S. cities in 14 states. According to intelligence reports, members of criminal groups in Russia are sent to reinforce and consolidate links between groups in Russia and the United States. Russian organized crime figures are also sent to this country to perform a service such as a gangland murder or extortion.

The Moscow Criminal Police reported as early as June 1991 that one third of the criminal groups in Russia were connected to the "shadow" or second economy.<sup>11</sup>

In April 1994, the Mafiya was estimated to have 55 percent of the financial capital and 80 percent of the privatization shares and vouchers in Russia. As a result, they were able to control the privatization process, arrange winning bids very much below market prices and arrange the outcome of the bidding in at least 70 percent of the privatization auctions.<sup>12</sup>

In April 1996, a senior officer of the Federal Tax Police Service was arrested for accepting a US \$ 200,000 bribe from one single commercial company. This was one of the few such cases ever prosecuted.<sup>13</sup>

However, perhaps the best recent example of the institutionalization of official corruption is the case of several Russian officials arrested in connection with the Solntsevo Mafiya. This is the same crime that was reported to be working with former KFB employee Boris Birsteyn to launder US \$ 150 million. Colonel Yevgeniy Zhigarev, a Higher Police School professor, testified that bribes from the Solntsevo crime family were distributed as follows. The prison counselor passed orders and "treasury money" to friends in law enforcement. The investigator collected information on the pertinent criminal cases, devised a plan to derail them, and by deception obtained the materials for examination

and falsification. The professor found middlemen to pass bribes to investigators and judges. There was a precise fee structure: for changing the measure to secure the appearance of the accused, for dismissing the case, for lessening the sentence. Freedom cost \$25,000 per person.<sup>14</sup>

Also in 1996, the Russian Newspaper *Trud* reported that the number of reported murders in Russia rose from 15,500 in 1990 to 32,000 in 1995, adding that many of these murders are the result of disputes over the division of the spoils of the market economy. Related to these disputes, there were a reported 500 "contract" killings in 1995 of which 61 assailants were arrested. Although 73 percent of the reported murders in Russia are solved, only 40 percent are solved in Moscow.<sup>15</sup>

In September 1996, *Komsomolskaya pravda* reported that regional political leaders use Mafiya groups in inter-ethnic disputes in order to maintain their political power. The article pointed out that many small businesses were also being set up by the Mafiya and that over 300 city officials in Moscow belonged to criminal groups. In addition, the estimated Mafiya turnover in Odessa is equal to the city's official budget.<sup>16</sup>

### **THE RUSSIAN MAFIYA IN THE US**

According to a 1996 report on Russian organized Crime (ROC) by the Office of the Attorney General of California, the following are a few "snapshots" of the activities of various Russian Mafiya groups in the US:

- According to the U.S. Attorney in Los Angeles, this group managed to avoid paying \$3.6 million in taxes in just one year: 1994. By using tax-free additives and manipulation of the ownership of their gasoline companies, the Russian Mafiya was able to retain 42-50 cents a gallon without paying any taxes.
- In Los Angeles, Russian organized crime figures have been involved in various frauds that run the gamut from staged auto accidents to false billing schemes. In 1991, in a case considered the largest of its kind, the U.S. Attorney's Office in Los Angeles charged 13 defendants in a \$1 billion false medical billing scheme that was headed by two Russian émigré brothers, Michael and David Smushkevich. The Smushkevich brothers were suspected of being part of a loosely organized Soviet crime syndicate operating in the Los Angeles area during the late 1980s and early 1990's.
- Colombian cocaine distributors are believed to have formed an alliance with organized crime groups in Russia to import large quantities of cocaine into that country. These ties became evident after a 1.1 metric ton shipment of cocaine was seized in St. Petersburg, Russia in February 1993.
- On September 8, 1993, several Russian crime figures were arrested in St. Augustine, Florida for conspiracy and intent to import 800 kilos of cocaine. These subjects were attempting to establish a drug distribution route from Florida to Detroit and New York. It is believed groups of Russian organized crime figures in Los Angeles and New York were part of this operation. The Russian group was dealing with Costa Rican drug traffickers and had plans to smuggle a large quantity of cocaine from

Colombia to Italy aboard a vessel. The Russian group was dealing with the Sicilian Mafia in this venture.<sup>17</sup>

According to the New York's Crime Task Force, Russian organized criminals cheated the US government of \$14.6 million only during the period October 1991 and December 1992 by setting up a series of dummy companies to sell gasoline without paying taxes.<sup>18</sup> In this case, this type of activity began in the late 1970's and allegedly resulted in the purchase of the sixth largest oil company in the US in 1985. Subsequently Getty Oil Company was the first US oil company charged with racketeering.<sup>19</sup>

The Russian Mafiya was "protected" and assisted by the Italian Mafia for this series of operations, which were extremely lucrative for the Italian Mafia. The FBI learned in 1983 that these two organizations were cooperating in another operation to bilk the Las Vegas casinos out of millions of US dollars.<sup>20</sup>

This does not include the large scale money laundering operations run by these groups which frequently involve the use of US banks and "paper" firms operated in the US, making "investments" in the former USSR and around the world.

### **WHAT DOES IT ALL MEAN?**

The evidence rather clearly illustrates that the majority of the commercial activity in Russia is controlled by organized crime, if we accept the latest estimates of 80 percent. If we accept the "best case scenario" of only 40 percent control by organized crime, the economy is still paralyzed in terms of actual free economic development. At the very least, the following points are clear:

- several powerful organized criminal groups exercise control over national economy;
- the corrupt government and law enforcement agencies serve as tools for organized crime groups; and, the formal country leaders are unable and unwilling to fight organized crime and corruption;
- there is still a severe shortage of democratic institutions and mechanisms, paralysis of the legal system;
- the market mechanisms are suppressed by organized crime;
- as is illustrated by the figures shown above, most informed observers agree that the criminal Mafiya groups account for only about 10 to 15 % of the makeup of organized crime, with Russian officials, former officials and their "newly created entrepreneurs" accounting for the other 85 to 90 %. In other words, the criminal Mafiya groups with ostentatious cars, bodyguards and flashy attire are only the most visible portion of Russian Organized Crime and are possibly much less dangerous than the more hidden "official" members of organized crime - whom the West consistently attempts not to see.

Today, it is virtually impossible for a profitable business in Russia to avoid control by the Mafia and extortion on a regular basis. Attempts at resistance to the Mafia is ruthlessly and effectively crushed by methods that include kidnappings, assassinations, attacks on the family members, or malicious persecution by corrupt government officials affiliated with the Mafia. If any doubts remain, consider that retired police general Gurov wrote

that in the course of 1994, organized criminals killed over 600 businessmen and bombed or raided over 700 company offices. Investigative journalists, members of the Duma and even policemen are now killed on a regular basis. Over 300 bankers have been killed since 1991, including the chairman of one large bank with known ties to the KGB.

Having demonstrated its power to the entrepreneurs and to the nation in whole, the Mafia in Russia now enjoys almost total power. The corruption reaches all the way to the top levels of the government, as the bribes for government officials now cost the organized crime groups up to 50 % of their billions of dollars in profits. For the Russian government, it is much easier to control corrupt officials, which can be easily controlled against the threat of jail sentences "for corruption" should they disobey. Most government officials have become integrated with the major organized criminal groups, because such partnership is the most effective way for their officials to profit from their power and strengthen their personal positions. The oligarchy, for its part, has obtained control over the government, including the law enforcement agencies, thus increasing its own power, security, and income.

The rights to private property in Russia may not even be considered as absolute, as control over property depends on the relative strength of the criminal group and other factors, not related to the legal rights to own it. The oligarchy as a whole took the place formerly occupied by the Communist Party which effectively owned all commercial entities and employed most of the country's population. Similar to how the Communist Party operated, the Mafia motivates its employees by threats and by financial means (salaries, bonuses, shares in the business).

Today the "owner" of a private factory finds himself in the position, similar to the position of the manager of the same factory when it was government-owned in the Soviet Union. Neither of them was entitled to the profit of the business, but both were financially motivated. As long as their masters (oligarchy and Communist Party respectively) were satisfied, both enjoyed the privileged living, carefully adjusted to the social status which their managerial positions secured them within the oligarchy or Communist system. If the managed business was profitable and important enough, then both the "owner" (under oligarchy), and the manager (under Communism), were entitled to a limousine, big apartment downtown, a luxury dacha in a prestigious suburb location, and high salary.

At the same time, Russia slides ever deeper into debt, without presenting a concrete plan to raise the funds to repay the old debts. As noted in this testimony, the influx of Western investment appears to be equal or slightly less than the total amount of capital flight. Consequently, the West is simply supporting a system of corruption which by nature, fails to have the desired effect of spreading economic reforms and democracy to the population. This information has been in the public domain since at least 1993, as this paper and my testimony before the House Banking and Financial Services Committee on September 21, 1999 have documented.

All of this information has been in the public domain and, worse yet, has been presented to not only the media but also the entire administration. And yet, nothing has happened and no one has listened.

As the US continues to "search for answers", consider that the Russian press continues to do a praiseworthy job of publishing facts and otherwise documenting corruption in Russia. While the Western press rarely publishes this material in the West, you can be certain that the Russians know about their own corruption and corrupt leaders in great detail. Recognizing that a newspaper article is not evidence in a court, you must also recognize that many of the most famous corruption investigations in the US were a result of published media reports. I - for one - do not believe that the US government - including the State Department, FBIS and other government foreign policy agencies - have quit reading the foreign press. Therefore, even if the US law enforcement and intelligence agencies had not been able to find any information or evidence of high level and massive corruption in Russia - and I do not believe that - then we would have to believe that the US administration also does not read the foreign press.

In my testimony before the House Banking and Financial Services Committee on September 21, 1999, I included several documented, public examples of how Russian officials planned and executed the looting of their own state. I even included publicly available copies of Swiss bank statements of Russian officials who work directly for Russian President Yeltsin as well as proof that this same official gave the two most senior prosecutors in Russia apartments worth \$ 500,000 each - in an apparent attempt to influence their official duties.

For this testimony, I include a very recent Russian media article that simply and directly explains what happened to most of the \$ 4.8 billion in IIMF funds that were transferred to the Russian government accounts on July 23, 1998, and who profited. While it is not evidence for the court, it seems as if it might be an excellent starting point for the US Government.

## **DEFAULT MEANS PUTTING ONESELF ABOVE SERVICE**

Article published by Novaya Gazeta in edition issued  
On September 27 - October 4, 1999

*We were right. The assumption made on  
"How 15 billion dollars could be stolen" has been confirmed by new facts.*  
(Reference is made to an article by Bulat Soliyarov)

In the 33rd edition, we have described the scheme that helped the senior executives of the financial sector to earn billions of dollars on the development and collapse of GKO pyramid. They have done it easily through associated companies that enjoyed access to insider's information about decisions taken by the Cabinet. According to our version, the rubles that were made on GKO trading were used to buy dollars at the currency exchange market (the fact confirmed by stock exchange players). In order to secure a maximum amount of dollars (and the possibility to take them abroad) exchanged for the minimum amount of rubles, the same bureaucrats urged the IMF to disburse credits for ruble stabilization. Consequently, they got an opportunity to buy an unlimited amount of dollars provided by IMF at the exchange rate of one to six.

We continue to examine our version and get convinced that an enormous number of new confirmations prove that we were right. Considering that Russia still does not have a mechanism of personal responsibility for financial decisions taken by the Government and the Central Bank, we can not put the blame on anyone in particular. However, it is common knowledge that decisions regarding GKO trading were taken by a narrow group of persons: Dubinin, Zadornov, Kirienko, Aleksashenko, Chubais and Gaidar. The country always knew its heroes.

First, let us speak about unimportant. It does not surprise us any more that many things are conducted illegally in our country. And still we have to state that first and foremost the people who decided to default on August 17, violated clauses 310 and 817 of the Civil Code which states that the State does not possess the right to change unilaterally the conditions of the debt issued for circulation including GKO bonds. This action violated Article 35 of the Constitution which states that **"nobody can be deprived of its property unless such decision is taken by a court"**, and that **"creditors' claims to the Central Bank should be examined at the constitutional level."** These are the victims who were justified by the objective set forward by establishing the financial swindle called GKO market.

The objective is clear. We can define with precision the purpose of the domestic debt pyramid, which collapsed on August 17, 1998. Its only objective was to enrich the players of the Russian stock market who were always represented by the Central Bank and companies close to the well-known state officials. We believe that in the last years of its existence, the GKO system did not have anything in common with state interests. Above all, the profitability of state securities was insane and was unwarranted. While the



securities in industrialized countries earn a return of not more than 5percent per year, in developing countries 10percent annually, and in under developed approx. 15percent, in Russia in the best times of economic development their return was up to 30percent, and in August of 1998 even up to 200percent. Taking into consideration that the Central bank, and institutions close to it, have always controlled not less than 50percent percent of the stock market, the federal authorities - had they really wanted to - could have lowered the profits of state securities that caused the pyramid to grow at a supersonic speed. However, such action was not part of the plans of the companies who earned excessive returns in the securities market. They needed a high and speculative anti-federal rate of return. We all remember those companies that were close to the Chubais - Aleksashenko group: MFK Renaissance Capital Group (Jordan), Montes Auri (Kokh), ONEXIM (Potanin), etc. Moreover, certainly, the group of the Central bank. The market players at that time would explain their confident behavior exclusively by the friendship between their leaders and state officials. They needed the state to guarantee the rate of profitability not at 10 -15percent per year (which is more or less reasonable), but at 30 - 200percent.

The federal authorities had another serious reason for maintaining such excessive interest rates for state securities: the Central Bank needed to show profits. For example, in 1997 the net income earned by the CB on GKO trading generated 5.5 billion rubles. In other words, by managing the financial pyramid on the eve of August 17, the CB was leading the country to default. The CB made interesting use of these profits. According to Yuri Boldyrev, vice-Chairman of the Audit Chamber, the audit in 1997 showed that the Central Bank had spent 7.5 billion rubles for administrative purposes. We may add that all the expenditures for state management in Russia were approximately equal to this while the volume of construction works, carried out by the CB without any interruption, was equal to the scale of residential construction in the entire country.

During the period from January to August 1998 the profits earned in the GKO market by the government and Central Bank bureaucrats had become enormous. At that time everything had become obvious even for the least educated people. In December 1997, the GKO market stopped to be the donor of the stated budget. In order to survive, the state had to prolong the life of the pyramid scheme and therefore started to pay off the bonds, although not with newly acquired assets - increasing the internal federal debt -but at the cost of the state budget. In other words, starting from December 1997, GKO trading had lost its value for the State budget. Rather, by replenishing the budget, it was draining up to 35percent of its revenues. The Ministry of Finance spent 600 billion rubles from the budget to keep the GKO market going. The bureaucrats started to fill their own pockets and as well as those of associated oligarchs. This was done at the expense of tax payers, such as miners, teachers, and physicians who suddenly were confronted with arrears of their salaries. It means that starting from 1997, it was completely senseless to issue new GKO's. What is more, the issuance of GKO's was criminal as it generated only more wealth for

the players in the stock market. The rest of the story is already known. As soon as it became clear that the federal securities market was about to collapse and the state could no longer sustain the pyramid scheme, the government received a number of projects proposing a civilized way of restructuring the domestic debt. None of this projects has ever been implemented. Persons well known by now, drove the annual interest rate for federal securities from 30 to 200percent and when there were no funds anymore with which to pay off the debt, they simply declared default. We assume that the country didn't need the GKO market in general, because its budgetary profitability existed for a short period of time and ceased already in 1996. However, if that was the case and these persons built the pyramid, it had to be restructured - at least in the period between 1997 and 1998. The government, however, was not motivated by the interest of the State. That is why no restructuring took place. It didn't take place because notorious people were able to gain great wealth exactly because of the collapse of the market in 1998. Restructuring could have provided a cushion to effects of a pyramid scheme with regard to its timing, but government continued to state that the pyramid was solid and the situation was under control - not only at the beginning of 1998 but also in August 1998. They brought about the default crisis which led to the following results: defaulted domestic debt of 400 billion rubles, losses suffered by the banking system of 150-200 billion rubles, catastrophic GDP and investments volumes, lowering of the country's credit rating and continuing deterioration of the population's living standards.

In edition 33 (D) we reported that around three billion dollars of our approximately five-billion Dollar IMF stabilization credit were bought out by state officials and their friends who made rubles profits on GKO trading. According to our experts' opinion, they have bought dozens of billions of dollars in the federal securities market. The CB used to sell around 100 million dollars daily replenishing its assets with IMF funds. In order words, by providing disbursement to stabilize the ruble, the IMF in fact contributed to launder the rubles illegally earned by notorious people in a pyramid scheme. Our experts estimate that the participants of the federal securities market bought approximately 70percent of all the currency available on the market.

P.S. Since the Constitution does not require state bureaucrats to assume personal responsibility for their decisions, all the attempts by citizens, State Duma and the Federation Council to initiate proceedings through the General Procurator's Office on the GKO case will be doomed to fail.

- <sup>1</sup> STATEMENT OF THE HONORABLE R. JAMES WOOLSEY, DIRECTOR OF CENTRAL INTELLIGENCE, ON INTERNATIONAL ORGANIZED CRIME AND NUCLEAR SECURITY to the House of Representatives, Congressional Record, June 27, 1994, Page: E1335.
- <sup>2</sup> National Drug Intelligence Center, October 1993, cited in the report "Russian Organized Crime", from the Office of the Attorney General of the State of California, Daniel E. Lungren, (State of California: California, 1996), March 1996, page 5.
- <sup>3</sup> Moscow "Izvestija", "Part Seven of Series entitled 'Who Wields power in Russia' ", in Russian, by Izvestija Analytical Department, 20 July 1994.
- <sup>4</sup> "Washington Times", "Most of Russia's Biggest Banks Are Linked to the Mob, CIA Report Says Illegal Activities Spread to the District", 5 December 1994, by Bill Gertz, p. A01. The article went on to state that the local Menatep Bank representative stated that his office does not take deposits in the US and a representative for the Russian Embassy stated that "he was not aware of any 'official' Menatep office" in Washington. However, in June 1997, the Menatep Bank representative was reported by the local newspapers to be seeking US \$ 3.2 billion in investments from US sources for the renovation of the Russian telecommunications industry.
- <sup>5</sup> STATEMENT OF THE HONORABLE R. JAMES WOOLSEY, DIRECTOR OF CENTRAL INTELLIGENCE, ON INTERNATIONAL ORGANIZED CRIME AND NUCLEAR SECURITY to the House of Representatives, Congressional Record, June 27, 1994, Page: E1335.
- <sup>6</sup> Phil Williams, "Hysteria, Complacency and Russian Organized Crime", Post-Soviet business forum Briefing No. 8, Royal Institute of International Affairs, October 1996, p. 5.
- <sup>7</sup> "The High Price of Freeing Markets," The Economist, February 19, 1994, p. 57.
- <sup>8</sup> Sunday Times London, April 10, 1994. Also See "The Russian Mafia" (Washington D.C.: U.S. Department of Energy, Office of Intelligence and National Security, Office of Threat Assessment, 1993); Stephen Handelman, "The Russian 'Maffiya'," Foreign Affairs 73 (March/April 1994), p. 83; Claire Sterling, Thieves' World, The Threat of the New Global Network of Organized Crime (New York: Simon & Schuster, 1994), pp. 34, 90; Mark Elliott, "Economic Crime and the Necessity of Morality," a chapter in William Clark, ed., Economic Crime and Market Reform in the Former Soviet States (Boulder, Col.: Westview Press, forthcoming).
- <sup>9</sup> Personal conversations in 1995-1996 with victims of car theft in Latvia and Russia as well as several Latvian police officials.
- <sup>10</sup> "Russian MVD Fights Shadow Economy and Organized Crime", as heard on Radio Rossii on 13 June 1991 in an interview with Chief of the Detective Division of the Moscow Criminal Police, translated in RFE Weekly News on 18 June 1991 by Victor Yassman
- <sup>11</sup> National Drug Intelligence Center, October 1993, cited in the report "Russian Organized Crime", from the Office of the Attorney General of the State of California, Daniel E. Lungren, (State of California: California, 1996), March 1996, page 5.
- <sup>12</sup> "Mafia Accumulating Property", translated from Russian language broadcast of radio station "Ekho Moskvy" on 22 April 1994, in RFE Weekly News on 26 April 1994. Quoted researchers from the Russian Academy of Sciences.
- <sup>13</sup> "Tax Police Colonel in Corruption Scandal", translated from Russian language broadcast of NTV on 9 April 1996, in RFE Weekly News on 26 April 1994
- <sup>14</sup> Moscow "Obshchaya Gazeta" in Russian, "Solntsevo Gang Members, Operations Revealed", 15-21 May 97, No 19, p 7, translated by FBIS in FBIS-SOV-97-104 of 21 May 1997.
- <sup>15</sup> *Trud*, 18 May 1996, as reported in RFE Weekly News, "Murder Wave", 22 May 1996, by Peter Rutland.
- <sup>16</sup> *Komsomolskaya pravda*, 24 September 1996, in RFE Weekly News of 25 September 1996 by Victor Yassmann.
- <sup>17</sup> "Russian Organized Crime", from the Office of the Attorney General of the State of California, Daniel E. Lungren, (State of California: California, 1996), March 1996, page 5
- <sup>18</sup> Reuters News, "Russian Mafia Expands into New Areas, Using the US to Launder Dirty Money", 1 November 1995.
- <sup>19</sup> *Vanity Fair Magazine*, "Brighton Beach Goodfellas", by Robert Friedman, January 1993, pp. 27-34.
- <sup>20</sup> *Komsomolskaya pravda*, "Russian Mafia in the US: Cosa Nostra Has Showdown with a Russian Pretender", 19 December 1996, p. 2, in RFE Daily Report, FBIS-SOV-97-042-S.

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**Reuters News, "Russian Mafia Expands into New Areas, Using the US to Launder Dirty Money", 1 November 1995.**

**Testimony of the Center for the Study of Transnational Crime and Corruption (TraCCC)  
at American University, Washington, D.C.**

**Russian Corruption and U.S. Foreign Policy  
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**Before the Committee on International Relations, U.S. House of Representatives**

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**GLASNOST II -- AN UNFINISHED RUSSIAN NATIONAL ANTHEM  
WITH AN EMERGING DEMOCRATIC CHORUS: RUSSIAN AND GLOBAL  
CORRUPTION IS AT A CRITICAL CROSSROADS**

Thank you Mr. Chairman and Members of the Committee. It is an honor for me to appear before you today and I will try my best to share my candid thoughts and reflections on my past and current anti-corruption work and welcome your questions. My main interest is in advancing a global and Russian anti-corruption agenda and in sharing both lessons learned during my tenure at USAID from 1993 to March 1999 and my current activities at The Transnational Center for Crime and Corruption (TraCCC) at The American University. You may know that TraCCC is the brainchild of my esteemed colleague, Professor Louise Shelley, who formed the center in 1995 with seed money from the MacArthur Foundation. Our main objective is to undertake academic and applied research on global crime and corruption problems, through creative multi-disciplinary partnerships with scholars and practitioners in targeted countries. With support from the U.S. Department of Justice and others, we have helped establish sister centers in four Russian cities and one in Ukraine. With the Chairman's permission I will try to summarize my testimony for the Committee.

In 1997, Elena Bonner, former dissident, human rights activist and widow of the Nobel Peace Prize laureate Andrei Sakharov, made an observation that I believe sums-up the current general state of affairs in Russia:

**"The intelligentsia seems to have abandoned its historic calling of compassion and assistance in the favor of grabbing crumbs dropped by the corrupt and powerful."**

Ms. Bonner further noted that while considerable freedoms had been achieved in a relatively short period of time, the collapse of the education and healthcare systems, forced military conscription, unconstitutional pre-detention law enforcement policies, abominable prison conditions and substandard wages and living conditions made many of the former concerns of dissidents look trivial. She called upon the international community and the Russian leadership to refocus its attention on core societal values and goals, such as freedom of the press and rooting out corruption. I believe her comments set the stage not only for today's discussion, but they also argue for a global anti-corruption summit and raise several important questions.

**QUESTION ONE. Is Corruption both a Russian and international problem that requires global solutions?**

Over 130 years ago during an earlier reform era, Czar Alexander II, as told by one French-Russian historian, identified Russian corruption as a centuries old problem that was a major deterrent to Russia's integration with the West. The historian observed that the causes of corruption that existed then remained applicable today (1896): (i) a society ruled by men not laws; (ii) a secretive, restrictive bureaucracy that stifles justice and the press and the development of strong state institutions; (iii) a weak civil society unable to check government action and (iv) a disdainful citizenry. These are the same core problems facing Russia today.

The political, economic and social problems facing Russia, the U.S., Europe and the global financial system stem in large part from our collective failure to fully acknowledge, understand or respond to what is now recognized as one of the biggest threats to global economic growth and political stability -- public and private "grand" corruption. This phenomenon has greatly limited the power of the State to play a positive role in developing society in countries around the world.

While the effects of grand or high-level corruption have negative economic and political consequences on all countries, including the United States, they have a disproportionate negative impact on developing and transition countries and any subsequently emerging middle class. Indeed, many development specialists of all disciplines, including economists, lawyers, political scientists, CEO's and policy makers, now believe that systemic corruption in developing and/or transition countries, such as Russia, makes long-term sustainable economic and political development virtually un-achievable. However, because most people in positions of power around the world, whether in the public or private sector, have chosen to treat grand corruption much like the global AIDS/HIV epidemic -- either under a cloak of silence or with rhetoric. **There is still no serious, concerted, holistic effort underway to address or prevent this regional and global phenomenon. From my perspective, most in the international business community, the family of multi-laterals and donors, as well as most public officials, are all moving too slowly and are behind the learning curve.**

### **Institution-Building**

There are myriad reasons why key reforms in Russia have had limited resonance. Many are truly beyond U.S. or European control and relate to Russia's embryonic embrace of democracy and capitalism and the unprecedented revolution underway. Thus, even though it has been ten years since the fall of the Iron Curtain, from a historical and pragmatic perspective, the notion that the U.S. or anyone else lost Russia seems at once premature, naïve and unrealistic. As this Committee knows well, it takes generations, not years, to build democratic institutions, a market economy, a viable civil society and a rule of law culture.

Some of the key musical notes absolutely essential to creating a Russian democratic rhapsody with an economic chorus have been written in a relatively short period of time. However, some notes must be re-written, harmonized and receive broader, sustained public and international support. The most important institution, **an independent media and investigative journalism**, is finding its voice, although it is still too weak and inexperienced to sing loudly or in key. The makings of an independent judiciary, in the form of Russia's new Constitutional Court, is also beginning to emerge.

### **Judicial Reform**

The Constitutional Court, and to a lesser degree the Supreme Arbitration Court, are beginning to resolve disputes between competing branches of government, private citizens and businesses, respectively, that will help protect the personal and private property rights of citizens and businesses. These judicial decisions and some of the legal reforms that have occurred are creating the legal

foundation necessary to sustain democratic and economic reforms. While some of these new rules of the game need further revision, the real challenge today is implementation and enforcement. Effective, fair, timely enforcement of these new rules will provide the missing notes to Russia's emerging national anthem and will ultimately determine Russia's long-term future and place in the new world order. This legal infrastructure and the evolution of a rule of law culture is absolutely essential to support a market-based democratic society and the empowering music of an independent media and investigative journalism.

### **Parliamentary Reform**

Whether one agrees with all of its policies or actors, a viable, independent parliament must also be part of the equation. In just a few short years we are beginning to see the Duma assume some responsibility for governing and taming the volatile and complex economic and political forces shaping Russia. Public participation through elected representation and a system of checks-and-balances no longer seems to be an illusory goal. As this institution becomes stronger and more representative, the melodies being written and/or edited by diverse parliamentary composers, in conjunction with other important voices within Russian society, should help generate more public support for democratic principles and free markets. This kind of public dialogue is essential to the consensus building process that must take place before corruption can be minimized and to sustain reforms.

### **Civil Society**

Most important, advocacy groups, political parties, business and professional associations and civic groups, at the local and national levels, are stronger and are beginning to play in harmony. In short, civil society is beginning to monitor more closely the overall direction and music-making process of Russia's orchestra leader. This is the most encouraging sign that Russia is on the right page of music, however slow its composition.

However, in order for this music to be captured in the hearts of Russians, we must refocus and redouble our collective efforts. This kind of prevention-oriented agenda should be balanced with a credible law enforcement agenda. Accountability, civil society oversight and institution-building are key watch-words of the day.

### **Global Anti-Corruption Dialogue/Treaty**

It is therefore incumbent upon the United States, along with its G-8 partners, to launch a global anti-corruption initiative. If the United States does not assume a leadership role in this endeavor, more financial crises, political and economic instability and poverty will likely result. Many transition and developing countries will never become part of the new world order and the mutual goals of economic growth and democratic governance will never be fully realized.



**QUESTION TWO. What lessons have the U.S., the multi-laterals and the international community learned through their experience in Russia?**

This is a difficult question to answer since events are ever-changing and remain embryonic. However, I will attempt to outline a few key points that stand-out in my mind, based upon my own personal efforts and observations made during the 1993 to 1999 time-frame. As the senior rule of law and crime and corruption advisor to USAID's Bureau for Europe and New Independent States from July 1993 to March 1999, I had the privilege and opportunity to play a small part in one of the most important and historical revolutions of our time.

For sure, the early reform days were exciting and challenging times, and many of us, like the Russian people, had high expectations that in retrospect were unrealistic. Our programmatic efforts were also undertaken without a holistic grand strategy and with little coordination with our European allies. Some of this was unavoidable initially, given time constraints, evolving volatile political events, our inexperience in the region and the complexity of the task at hand. However, over time it became clearer that there were some "underground" forces at work and that they were stifling many important economic and political reforms.

**Support for small patronage networks**

Ten years after the fall of the Iron Curtain, there is growing evidence that the informal and formal patronage networks that existed prior to the break-up of the FSU are either still intact or stronger than ever. This is true both in-country and transnationally. The result is systemic private and public corruption that makes sustainable economic and political reform extremely difficult if not unattainable. Democratic pluralism, a system of checks and balances and an independent media and judiciary are still only ideals captured on paper and are not a reality.

Corruption within the law enforcement community and the judiciary presents the highest barrier to sustainable political and economic development. Many believe that until this conspiratorial network and unreformed bureaucracy is cleaned-up, that little can be done to address organized crime and corruption. Fundamental civil service reforms, the adoption and effective but fair implementation of international law enforcement protocols and new criminal procedure codes must be undertaken as a first step to sustainable reform

**Failure to make judicial reform and fighting crime and corruption a high priority issue**

According to various business surveys, the twin problems of organized crime and corruption, coupled with "unpredictable judiciaries", seriously impedes long-term trade and investment. The result is that GDP has fallen dramatically since 1989 and public trust and confidence in democratic free markets has been badly shaken. In addition, many believe that no real middle class with is emerging.

These three inter-related problems promote capital flight, money laundering and organized crime, inhibit institutional and political development and the free flow of information. The result is

that the banking and financial systems in these countries are under-regulated and are often controlled by organized criminal networks and/or corrupt public officials and private sector oligarchs.

### **Western Complicity**

There is also growing evidence that "Western" private sector complicity in playing by the current corrupt rules of the game is an important factor that both discourages the development of a rule of law state and encourages public cynicism. Too often U.S. advisors act as intermediaries or facilitators between corrupt public officials and the private sector and appear to have sometimes unduly influenced U.S. foreign policy for their own private gain.

**Donor Corruption.** Donor non-transparency and non-accountability comprise another part of this problem. The public does not have access to the details of various loans or reform programs and thus can not serve to monitor government or donor activity and the proper distribution of funds. Corruption within the donor community or associated with donor programs negatively impacts public perception and confidence and stifles the emergence of a middle class with vested long-term interest. While recent public and business surveys in Georgia and Albania indicate that donor corruption is perceived as less serious than corruption within the law enforcement community (including tax and customs), it is seen as a contributing factor to the overall corruption problem. This finding may be significant since there is little serious investigative journalism or reporting on this topic in either the Western or FSU press. Moreover, few high-level public officials or rich businesspeople are ever held fully accountable.

Current IMF, World Bank or USAID staff guidelines still do not require formal corruption analyses in their overall country reports or strategies. Even when corruption is deemed to be systemic, no formal loan or program conditionality is required and there is no consensus among donors as to what the minimum terms of conditionality should be. There is very little information sharing among either donors or between donors and the national or international law enforcement community.

Even today most donors do not have clear employee or contractor guidelines related to their obligation to report serious corrupt acts internally or externally. Moreover, they do not have the auditing or oversight mechanisms or staff to monitor programs or loans, much less the political will. Indeed, donors do not want to become more accountable and see this function as someone else's problem.

**Financial Sector Corruption.** Continued reliance on some of the financial institutions and outdated rules — both in the West and in Russia, coupled with our seemingly blind or naive eye, is also part of the complicity problem. Our failure to fully acknowledge and understand that some of these institutions are criminally controlled and that some march to the tune of corrupt public officials and/or entrepreneurs, is a problem yet to be seriously addressed by anyone. Recent country, regional and global financial crises, such as occurred in Russia, Indonesia, South Korea and all point to the need for prompt and concerted action.

**HIID and Bank of New York Cases.** Elements of the Harvard Institute for International Development's Russia reform investigation and the Bank of New York money laundering case, while not factually analogous, both illustrate many inter-related corruption problems both inside and outside the donor community, as well as the serious development and law enforcement challenges confronting all concerned.

Whatever the facts and findings in the **Bank of New York** money laundering case, it is representative of larger, inter-related global problems: **Weak, non-transparent, global and country financial systems, poor oversight and accountability, strong transnational criminal networks and official and corporate corruption.**

Inadequate governmental and non-governmental oversight of public and private players and public funds, coupled with weak law enforcement and unclear laws, has led to myriad and compounded economic and political problems for both Russia and the U.S. A lack of competition within the **public procurement process** and too much government **political intervention** are also significant contributing causes of the resulting problems in both cases.

These cases illuminate the need to enhance competition and structure corruption safeguards into programs at the outset. These safeguards should include "**know your employee**" rules, as well as "**know your customer**" rules. This is particularly important when dealing with little-known people and institutions. In both cases it appears as though donor funds were misused and that people in positions of trust were colluding with corrupt public and private sector people and entities.

These cases also clearly illustrate the need to enhance **international law enforcement cooperation** and accountability and the need to concentrate on **financial sector, corporate governance and internal donor reforms**. Other key **high priority** reforms include: (i) the adoption of international accounting and auditing standards that promotes fair audits and shareholder accountability (ii) progressive bankruptcy codes that allow enterprises to reorganize fairly and quickly (iii) international public procurement codes and regulations that ensure competition promote transparency and (iv) transparent (post) privatization processes.

Some of the people involved in both cases appear to have ties to corrupt former and current public officials as well as to corrupt private sector businessmen and/or organized crime figures.

We do not know exactly how these cases will unfold; however, the cast of seemingly linked characters/entities and the complexity and depth of some of their questionable activities, calls into question the USG process and laws by which these individuals were originally employed and operated.

In short, multiple criminal investigations related to several individuals involved in different transactions are underway in both cases and the USG's and business community's integrity and reputation has been called into serious question. The long-term economic and political fall-out on USG relations with Russia, the financial community and on reforms in general, is not yet fully understood.

### QUESTION THREE. When Did We Know That Corruption Should be a Serious Issue?

**1994/95 -- The Loans-For-Shares Scheme and the Yeltsin Crime Decree.** Reasonable people can certainly disagree, to a point, on this question. However, I believe in hindsight that most analysts now identify the 1995 "loans-for-shares" scheme as a clear indication that some of the "reformers" we were working closely with had ulterior, self-interested motives. That event, coupled with the 1994 Yeltsin Organized Crime Decree, which gave the Ministry of Interior almost limitless powers to arrest and prosecute individuals outside the scope of the new Russian Constitution, should have sent important signals to all that organized crime and corruption was occurring at very high levels within the Russian Government. An international outcry ensued but was summarily rejected by the Russian government.

I do not pretend to be an expert on the loans-for-shares scheme and I do not know all of the facts intimately. However, no one seriously questions the fact that the scheme had serious flaws that called into question the motives of key "reformers."

Even Anders Aslund at Carnegie, a well and highly respected former Chubais protege and long-time Russia watcher, acknowledges that this scandal "blemished" both Chubais and large scale privatization in general. In an October 1999 *Foreign Affairs* article, Aslund notes that a few large banks were allowed to privatize some enterprises at auctions that they controlled. Many lawsuits and volatile wars among bankers and the managers of these enterprises occurred both during and after this process. In the end, while only 15 enterprises were involved, several notably represented some of Russia's most valuable assets -- oil: Yukos, Sibneft and Sidanko. He observed that the new majority owners did not behave like self-interested proprietors but just continued the management theft -- primarily by selling the products below market prices to their own trading companies.

Aslund then goes on to observe that the barrier to reform in Russia has never been the workers or the people, who have been exceedingly complacent. Rather, the threat has always come from elites who want to live on corruption. **I concur with Aslund's analysis and conclusion that the best way to control these kind of "forces" is through effective democracy.**

Other circumstances that raised more suspicion in my own mind related to the fact that the USG knowingly made a decision not to properly oversee implementation of HIID's critical legal and economic reform program that the HIID contract was awarded non-competitively, and that my late 1994 request for an Agency report regarding exactly who we and the World Bank were planning to provide tens of millions of dollars worth of assistance to within the Russian Government was first accepted and then denied without a full explanation (see the 1996 GAO HIID Report # 97-27).

**April 30, 1996 -- Congressional Testimony Before the House Committee on International Relations.** Professor Louise Shelley, now my colleague at The American University, Louise Freeh, the Director of the F.B.I., and Eric Seidel, Deputy Attorney General in New York, John Deutch, Director of the Central Intelligence Agency, and others, were among the first to publically sound an organized crime/corruption warning call with respect to certain forces operating

within Russia and the United States. Director Deutch noted "that a link between the governing elite and the criminal elements impedes the ability of the Russian Government to meet the population's expectations of social justice, a quality of opportunity and improved living standards." He also noted that the law enforcement forces were understaffed, underfunded and plagued with corruption. Professor Shelley, Director Deutch and N.Y. Deputy Attorney General Seidel also testified that organized crime's hold on the Russian banking community was a serious problem that had to be addressed. Finally, several noted that Russian organized crime was estimated to control up to 40% of the Russian economy.

#### **1997 – The First Anti-Corruption White Paper and Strategy**

During the spring of 1997, upon my own initiative but with the blessing of USAID's Europe and New Independent State's Bureau, I authored the U.S. government's first white paper on corruption. Over the next six months, this paper was discussed in an number of interagency settings and with various individuals inside and outside of government. This paper, which outlined the causes of corruption in the FSU and possible programmatic solutions, was adopted as the official USAID strategy for addressing corruption in the region in the winter of 1997. Key elements of this holistic strategy, which focused on mutually supportive trade and investment, good governance and civil society issues of common interest, were later included in the State Department's first formal policy statement on Russian corruption in late 1997 or early 1998. I submit it for the record as an attachment to this testimony. **That said, a comprehensive anti-corruption initiative, with or without donor support, has yet to be launched in Russia.**

#### **QUESTION FOUR. What Can Be Done To Address Corruption and What are Some Of the Lessons Learned?**

**First.** Do not attempt to create big or little czars or czarinas. Putting all of your reform eggs in one basket without broad public participation, support and oversight is a recipe for failure. It also undercuts fundamental democratic principles and opens up the process to corruption.

**Second.** Insist on transparency within the donor community. On the giving end, the public has a right to know how their money is being spent (developed countries); on the receiving end, the public has a right to participate in the decision-making and monitoring of this money (developing and transition countries). I can not tell you how many times I have been told by donors and potential donor recipients that corruption is rampant within the old boy network that exists both here and abroad. Potential recipients and everyday citizens are now very suspicious of the U.S. and others offering to lend them a helping hand.

**Third.** Advance an international Global Anti-Corruption Treaty and Minimum Terms of Conditionality for donors that is prioritized and mandatory. Donors could not make specified kinds of loans or participate in certain reforms unless these minimum terms were agreed to in full. Adequate support for an independent judiciary, media and civil society, as well as health and education programs, must be part of this package.

**Fourth.** Give the OECD Anti-Bribery Treaty and the Organization of American States Anti-

Corruption Treaties some impetus and teeth. More intensive, creative monitoring mechanisms that include civil society and business community oversight must be part of this package. In addition, international corporations should be held legally accountable for corrupt complicity. Strengthening key multi-lateral organizations and enhancing the U.S. diplomacy and capacity to implement foreign policy is an essential step in the new world order.

**Fifth.** Enhance international law enforcement cooperation/communication through more informal and formal structures/procedures. More regional, sector focused, interdisciplinary training programs that are tied to short and long-term reforms and strategies are needed so that people (properly vetted) can develop mutual trust and share transnational "knowledge."

**Sixth.** Promote the flow of "corruption" information among donors and between donors and the law enforcement community. This should include legal and ethical obligations that all requires government employees and businesses to report on "suspicious transactions." Passage and implementation of Access to Information, Whistle-Blower laws and policies that provide legal and political protection to whistle-blowers, prosecutors, police, judges, policy makers and journalists is paramount. Until the "code of silence" is broken and "culture of secrecy" within governments there is little hope of exposing or rooting out corruption.

**Seventh.** Promote more competition in the public procurement process and international best practices and good governance principles in both the private and public sectors. Many international best practices and standards have or are emerging within the last few years but most countries, particularly those in the transition and developing world, do not know whether or how to implement them. Particular attention should be given to some of the hard work that has been done by various international bodies including the World Trading Organization, the Organization for Economic Cooperation and Development and various professional international business and trade associations (e.g., accounting/auditing/banking/corporate governance/trade and investment, etc).

**Eighth.** Promote more long-term institution-building/reforms related to entities that can provide a check on governmental action (judiciaries, financial regulatory bodies, independent auditing agencies, ombudsmen, small business associations, advocacy groups, etc).

**Ninth.** Promote policies that promote more cooperation between the executive and parliamentary branches and more interagency coordination.

**Tenth.** Promote more academic and applied research related to understanding the causes and costs of corruption -- particularly the full economic and political impact of systemic corruption. More private-public partnerships are needed in order to create viable solutions to complex problems and to stay one-step ahead of organized crime and corrupt public officials.

**Eleventh.** Enhance communication and engagement within the global and intelligence communities, donors and the business community and more due diligence needed to protect the global financial system and donors. "Know your customer" and "know your employee" rules need to be strengthened..

**Attachment: 1997 USAID Anti-Corruption White Paper**

**WHITE PAPER**  
**CORRUPTION IN THE EUROPE AND NEWLY INDEPENDENT STATES HAS**  
**HISTORICAL AND CONTEMPORARY CAUSES AND THREATENS RECENT**  
**DEMOCRATIC AND ECONOMIC REFORMS**

**SCOPE OF THE PROBLEM AND SUMMARY RECOMMENDATIONS**

Since the bi-polar political alliances of the Cold War have largely ended, countries in the ENI and around the world have begun to place the political and economic spotlight on a common problem -- corruption. While there is no generally accepted definition of "corruption", for present analytical purposes, this white paper defines it simply as the misuse of public office for private gain. The specific ENI focus is on what some call "grand corruption", such as high-level bribery, procurement fraud, embezzlement and customs and tax evasion. These activities are often directly related to or part of organized criminal activities. [It should be noted that while many of the issues in this paper relate to a number of ENI countries, much of the information and commentary relates more to Russia and the Newly Independent States, since that is where most of the research on this subject has been done to date.]

Corrupt governmental practices are deemed to be widespread governance problems that serve to both nourish organized crime networks and negatively and simultaneously impact host country economic growth, trade and investment and the development of democratic institutions. They also have significant negative impact on the activities of the international business community, as well as the emerging middle class and professions in these countries, and inhibit entrepreneurship and the development of a pluralistic rule of law society. In the final analysis, these emerging constituencies are the chief beneficiaries of the reforms underway and they represent the coalition of interests necessary to root-out corruption and sustain economic and political reforms.

While the scope of this paper is limited to governmental corruption, it should be acknowledged that the lines between the activities of the governmental and business communities in many of these countries are quite blurred. Thus, corruption issues more directly related to corrupt corporate governance activities clearly need to be addressed alongside governmental corruption; however, that set of complex issues will be addressed in a separate paper.

Having said that, it is important to examine the corruption issue into a larger context, because of the interrelationship between the issues of democratization, trade and investment and economic growth. Similarly, the lines between activities related to organized crime and corruption are also very blurry. Organized criminal elements are perhaps some of the greatest beneficiaries of corruption, as they are taking full advantage of countries

that lack the laws, regulatory systems and democratic institutions necessary to support market-based democratic societies. Because of the complex relationship between all of these USG priority areas, policy makers necessarily need to view the corruption issue as multi-dimensional and of wide-ranging impact and importance. Other important related issues not explored in this paper pertain to narcotics and national security concerns, such as nuclear smuggling. The USG should commission another paper focused on these crosscutting issues after a targeted field assessment is completed.

In summary, the report attempts to outline the problem, as well as some of the key policy issues and short and long term programmatic options. It also advances several USG ENI specific recommendations, including:

1. That the U.S. law enforcement community conduct an assessment of its existing efforts to combat organized crime to determine whether corruption issues are properly incorporated into its objectives, strategy and programming.
2. That the USG broaden the substance and geographic reach of its anti-corruption agenda by moving beyond OECD countries to include targeted countries of the developing world; current U.S. objectives focus on promoting WTO procurement code reforms and requiring OECD countries to make it a criminal act to bribe foreign procurement officials (to pass a law akin to the U.S. Foreign Corrupt Practices Act) and on prohibiting countries from allowing companies to such make bribes tax deductible.
3. That the USG develop an international anti-corruption strategy, which may include the promotion of a regional or global anti-corruption treaty -- perhaps by building upon the Inter-American Anti-Corruption Treaty and/or the Council of Europe's current efforts to develop a similar treaty for Europe.
4. That USAID, on a country-by-country basis, assess the need, in collaboration with the EU, for incorporating more specific anti-corruption technical assistance components into its core civil society, institution-building and privatization/economic restructuring programs.
5. That USAID develop a regional anti-corruption initiative that is complementary to the current USAID core program that is part of a broader regional and global strategic effort.

#### **SURVEY OF RESEARCH (also see attached)**

A survey of the growing literature and research is revealing in that it shows that much of what we now know about corruption has been learned in the last decade or so and that there is still much we do not know. This fact is true for both the developed and developing world. Only recently have academics and



practitioners begun to acknowledge corruption as one of the greatest post Cold-War threats, alongside other major issues such as illegal immigration, illicit trafficking in nuclear and chemical weapons, transnational organized crime and today's all important battles for free and fair trade, economic development and democracy. There is also a growing recognition that it is especially important to address the anti-corruption issue in the emerging societies of the former Soviet Union -- where an unprecedented economic and political revolution is still in its embryonic stage.

While it is difficult to quantify the economic and political cost of corruption, since it is essentially a consensual crime and often goes unreported, there is a growing consensus that it is a serious barrier to the national security, political and economic goals of the United States. For example, a recent report by the U.S. Department of Commerce estimated that the U.S. business community lost approximately \$11 billion in foreign contracts to bribery alone in 1994. At the same time, there is almost unanimous agreement that corruption is a very complex socio-economic problem that requires a multi-faceted global response.

A strong argument can be made that the time is ripe to address the corruption problem within a broader strategic framework. Various forces are driving the need for action, including a sea change in public attitudes as a result of various forces arising out of an emerging democratic globalized economy. Today, the public has access to much more information about the way in which their governments operate, allowing them to hold their governments more accountable. Also, the emergence of more rule of law societies and independent media have resulted in more business interaction and an engaged and growing civil society. As a consequence, a new global culture and methodology for relating to each other, as exemplified through the growth of international law (such as the World Trading Organization and the adoption various international treaties) is now taking shape, a fact that will redound to the benefit of all.

#### **HISTORICAL PERSPECTIVE AND CAUSES OF CORRUPTION**

Our picture of corruption is necessarily being constantly recolored, as we learn more about its causes and nature and the countries in which we are working and investing. New information technology and dramatic global economic and political forces are also sharpening our image. The international political and business community, as well as a more engaged and vested citizenry, now seems less likely to accept corruption as a price to pay to maintain certain political and business alliances.

An historical perspective is also important to understanding and appreciating this global issue. Whether we are talking about the days of Peter the Great during 18th century Russia, Louis XV

during 19th century France, or South Korea, Italy or Mexico in the 20th century, corruption has been a serious, although infrequently, discussed phenomenon.

In 1894, a French/Russian scholar, Anatole Leroy-Beaulieu, identified corruption as a centuries old problem for Russia that was a major deterrent to Russia's becoming part of the world community. Indeed, many of the causes of corruption he identified then seem equally applicable today: (i) a society ruled by men instead of by laws; (ii) a secretive, restrictive bureaucracy that stifles justice and the press and the development of strong state institutions; (iii) a weak civil society unable to check governmental action and (iv) a disdainful citizenry.

As previously mentioned, the causes of corruption have many historical, contemporary and tangled roots. One of the main distinctions between the problem in Russia and that of the more developed world is that it appears to be systemic throughout society. In other words, corrupt practices are an acceptable and often necessary method of making things happen on an every day basis in Russia. In effect, they are the established "rules of the game." By contrast, in the more developed world, corruption is a violation of the "rules of game itself." Whether in the developed or developing world, experience has taught us that when corruption is fully exposed, it has sometimes literally rocked the political leadership of governments as well as huge multinational corporations.

One of the fundamental policy issues is whether corruption should be considered a high priority developmental issue for many of the countries in the ENI. Based upon what we now know about the impact of corruption globally, as evidenced by USAID's experience in Latin America and Africa, as well as recent reports from Ukraine, Russia and Romania, the answer would appear to be that it should be.

One organization attempting to measure how corrupt the business community perceives a country to be is Transparency International (see Corruption Perception Index attached). It is interesting to note that the bottom third of the 54 countries surveyed is occupied exclusively by developing and former communist countries. Nigeria is last, China 50th, Russia 47th, India 46th, and Indonesia 45th. The lowest ranked of the Western countries is Italy at 34th. The resulting picture leads one to believe that corruption is an acute problem for the developing world, which is a place where political and economic stability and economic growth are very sensitive and important issues. It may also be one of the main reasons why some previous reform efforts have not been entirely successful.

In summary, the causes of corruption, at least in Russia where we know the most, are believed to be largely attributable to the following factors:

1. History/ethos -- Russia's autocratic and communist system of governance over the centuries, except for short-lived pockets of reform, has resulted in systemic corruption and anti-government public attitudes.
2. Nascent economy and fledgling institutions -- the legal infrastructure is still not in place, including the regulatory stems necessary to implement the economic laws and a reformed law enforcement community and independent judiciary capable of enforcing them (and resolving economic disputes fairly and effectively).
3. Uncommitted political leadership seeking to retain power and make money -- high-level political commitment and integrated and sequenced programmatic responses to reform are essential elements of success; otherwise trying to mix untamed capitalism with a patrimonial institutional environment may only result in a breeding ground for "more of the same."
4. Little governmental accountability/transparency or power-sharing and no system of checks and balances exists -- policies and procedures for governing, promoting trade and investment and collecting and distributing resources (such as laws and policies related to procurement, tax, and customs, a weak and non-reform oriented parliament and weak judiciary) are often unclear, unenforceable, unfair and conflicting.
5. Unacceptable budgets and political support for key institutions and crime and corruption initiatives -- without the necessary resources and political support key institutions can not implement and enforce the laws and regulations fairly and effectively.
6. An embryonic civil society incapable of supporting and checking governmental action -- few effective government watchdog and advocacy groups exist.

#### ENI ANTI-CORRUPTION ACTIVITIES AND OPTIONS (also see attached)

To date, the corruption issue has received relatively little political attention in most countries of the ENI. Indeed, the issue has been addressed largely through indirect but important means. Specifically, major donors, including USAID, the EC and the World Bank, have embraced a more conventional prescription for this illness, namely, support for key democratic reforms and processes, including free and fair elections, and basic market reforms, such as privatization, decentralization and financial and administrative regulation. All of these activities, including reducing the incentives for bribery and eliminating subsidies, trade restrictions and preferential treatment in governmental purchases, along with new regulations in the financial, securities, environmental and consumer protection

sectors -- even while deregulation and privatization initiatives are underway, need continued strong support.

The most directly related USG effort has been largely focused on addressing transnational organized crime issues. This initiative is currently being implemented by various USG law enforcement agencies and includes training programs for law enforcement officials and technical assistance in the development of laws and cooperative procedures to address crimes as moneylaundering, narcotics trafficking, nuclear smuggling and environmental crimes. The European Community has a similar law enforcement anti-crime program in place, but it also includes programs related to illegal immigration. It has more recently launched a separate anti-corruption initiative through the Council of Europe, which is now in the process of conducting country assessments and linking this program to its anti-crime initiative.

There is a growing recognition that corruption is feeding the growth of organized crime. Many believe that it is critical for developing countries and the international community to move quickly to contain this growth before it becomes part and parcel of the new economy and body politic. If that unholy alliance between organized crime and the business and governmental communities occurs, experience in countries such as Italy has taught us that it may take generations to break the back of organized crime -- which by then is capable of exporting crime and reversing hard-won economic and political reforms.

As previously mentioned, recent economic and political global forces, coupled with the efforts of an emerging free media, as well as experiences in other countries such as South Korea, Mexico and Italy, all point to the need to expand the anti-corruption prescription beyond basic economic policy and institutional reforms. Clearly, a first, fundamental step needed in many ENI countries is to place increased emphasis on initiatives that increase the demand for reform within the governmental and business communities and the public at large.

What would appear to be needed is a larger strategic framework to address the interrelated, transnational issues at hand, as well as a more sharpened political and demand-driven programmatic approach that allows those with the most to gain from reforms to better understand the real political and economic costs associated with corruption. Obviously, implementing such a program requires considerable time, coordination, resources, and political support from both the host country and the international community. Targeted assessments and design exercises, done in coordination with the EU, need to be undertaken.

The next step, then, is for a targeted assessment to be done followed by the development of a regional strategy that can be used as the basis for a coordinated regional initiative that

complements our current efforts but addresses the problems at hand more directly. Special emphasis should be given to issues related to transparency in government, such as institutional procurement procedures and intergovernmental relations, and providing the bureaucratic incentives necessary to promote and sustain reforms, such as civil service reforms.

Serious strategic consideration also needs to be given to implementing components of any new initiatives under the auspices of the World Bank or another multilateral organization such as the OSCE. The OAS/Inter-American Anti-corruption Treaty, or the current treaty efforts of the EU/Council of Europe, may be the right models for ENI consideration. In any case, USAID's experience and our new grasp of this complex, transnational problem, all point to the desirability of working in a multi-lateral, leveraged manner when possible.

In summary, next steps should include the development of programmatic responses that promote:

1. International "best practices" principles related to transparency, efficiency, ethics and competition in government and business.
2. Civil society development -- including citizen and business education campaigns, advocacy and government "watchdogs" groups and oversight mechanisms focused on exposing and preventing corruption.
3. More academic anti-corruption research and exchanges as well as anti-corruption training programs and support for journalists, judges, prosecutors and police.
4. Laws, regulations, institutions and financial systems necessary to effectively and fairly protect property rights, attack and prevent corruption and enforce the laws.
5. The development of an ENI regional anti-corruption strategy and integrated and coordinated programming.

*Attached as an addendum is an overview of current anti-corruption policies and programs by all major donors, as well as some examples of successful models that have been developed in other parts of the world. Also attached is a fairly recent bibliography which summarizes many of the research papers that have been written on this topic.*

**attachments:**

1. Summary of Donor Activity
2. Summary of Research
3. Executive Summary
4. Programmatic Options

## DONORS CURRENTLY ENGAGED IN ANTI-CORRUPTION ACTIVITIES IN THE ENI

### I. European Community (EC) and Council of Europe (CoE)

The EC, in cooperation with one of its sister organizations, CoE, has recently launched an anti-corruption initiative in the ENI. This initiative is being developed alongside a related EC/ENI anti-crime program, which is primarily focused on specific law enforcement problems related to international organized crime, such as moneylaundering, narcotics, nuclear smuggling, environmental issues and illegal immigration. The CoE is in the process of undertaking country anti-corruption assessments (the majority of ENI countries are signatories to the Guidelines of the CoE and Covenants of the EC) and designing country programs. Among other things, its regional strategy calls for:

1. The necessary legislative and regulatory measures, including transparent financial systems;
2. The development of interagency and international cooperative mechanisms to prevent and combat organized crime and corruption;
3. Effective protection for individuals providing information or seeking to enforce the law;
4. New specialized bodies to fight crime and corruption;
5. Technology and training for targeted law enforcement bodies.
6. Country participation in key multilateral documents and treaties that establish standards of practice and cooperative procedures for combating crime and corruption.

One of the EC/CoE's key objectives is to develop an international anti-corruption treaty for all of Europe (including most of the ENI), by the fall of 1997. A cursory review of the draft convention reveals that it includes many of the same principles and provisions as the previously mentioned Inter-American Anti-Corruption Treaty. Specifically, they both (i) establish a strategic framework (ii) recommend the development of regional and country specific initiatives (iii) require the adoption of specific good government practices and (iv) set-forth the procedures for international cooperation.

### II. World Bank (Bank) and Economic Development Institute (EDI)

One important international development is that The Bank's new president, James Wolfensohn, intends to make this issue a high priority for the first time. He recently drew attention to

deduction). Led by the U.S., this two-decades old effort appears to finally be reaping dividends, and there is optimism that member countries will agree to pass such a law by the end of 1998.

However, OECD is not the appropriate mechanism to develop any ENI initiative since OECD membership does not include any ENI or developing countries.

#### IV. World Trade Organization (WTO)

The successor to the General Agreement on Tariffs and Trade (GATT), the WTO is the new world trading organization charged with developing and enforcing the new "rules of the game" for transacting international trade in most sectors of commerce. Under the leadership of USTR, the U.S. is one of its most active members. One international standard being promoted that directly relates to corruption concerns the adoption of competitive and transparent government procurement procedures and policies (these procedures are similar but more specific than those promoted by the UN). The U.S. has endorsed both the WTO and UN Procurement Guidelines but is actively promoting those under WTO as a model for all member countries (including those in the ENI).

#### V. United Nations (UN)

Most of the work of the UN on corruption was done in the 1970's and 80's during a failed attempt to develop an anti-corruption treaty. For a variety of reasons, many of which would not appear to be relevant today, that effort was not successful. In recent years, the UN Crime Commission has primarily focused on helping organize workshops and collecting and disseminating information related to organized crime and development criminal justice reform issues.

The UN has also played a leading role in developing and promoting the UNCITRAL procurement rules -- which set-forth general standards and principles for government procurement. Through UNDP, it also implements rule of law type programs, many of which are focused on human rights issues.

In 1996, under U.S. leadership, the UN adopted a resolution that requires countries to make it a crime to bribe foreign procurement officials and to eliminate the tax deductibility of such bribes (mirroring the previously mentioned OECD initiative). In theory, this resolution must now be implemented by all UN member countries (including the ENI).

#### VI. U.S. Department of State (State)

As previously mentioned, much of State's focus to date has been on economic issues related to U.S. business interests, e.g., making the bribery of foreign procurement officials a crime and

ending the tax deductibility for such bribes (State/Office of International Investment). It appears that this twenty-year effort has achieved some recent success and that this agenda will be largely accomplished by the end of 1998 (although efforts to ensure country implementation and compliance will necessarily need to be continued). Other USG priorities include support for the WTO procurement standards (USTR and Commerce) and anti-crime law enforcement training efforts (State/INL). There is no one entity at State coordinating work in these related areas.

## VII. United States Agency for International Development (USAID)

As previously mentioned in the White Paper, aside from USAID's core program in many countries, e.g., institutional and economic reforms, most of its directly related anti-corruption experience pertains to Latin America and Africa. While these regions admittedly may be distinguishable from the ENI in a number of ways, a review of these programs and the kinds of problems they are attempting to address reveals that they contain some models and lessons learned relevant to the ENI.

In Latin America, the traditional method of governance is similar to some countries in the ENI. There, a public official's duty is inseparable from the patrimonial obligation to family, clan, clique or party. Likewise, the state is the primary property owner, producer, financier, investor and employer. Official salaries are unacceptably low and "speed money" for every virtually every official action is still custom in many countries. Here, USAID is funding public education campaigns, the formation of anti-corruption chapters and coalitions and is promoting country implementation of the Inter-American Anti-Corruption Treaty. Similar programs are supported by the Africa Bureau, although no regional anti-corruption treaty exists there.

In addition, some countries in Africa appear to be having some success with a new model program based upon an "islands of integrity concept." In this case a specific problem is identified and analyzed and the governmental entity charged with addressing the problem is reformed and "isolated" from the rest of the corrupt bureaucracy. Much of the analytical product is devoted to highlighting the full costs of corruption, the benefits of reform, and the options to address the specific problem. It receives the necessary support from the highest level officials and builds-in bureaucratic incentives and protection into its overall program.

As in Latin America, a number of post-Colonial African countries, neo-patrimonial regimes also became the rule and bribery a common aspect of governance. Indeed, some believe that corruption-funded patronage to kinsmen and cronies has exacerbated regional, tribal, religious and ethnic divisions and contributed to a continual fiscal hemorrhage. The impact and form of corruption in one African country may be instructive.



The International Forum for Democratic Studies estimates that in oil-rich Nigeria some \$12.2 billion in government revenue was divested to "extra-budgetary accounts" between 1988 and 1994, and there are no records of how these funds were used. Even though oil earnings have steadily increased over the years, Nigerians' standard of living has fallen dramatically (per capita annual gross income fell from \$950 to \$300 from 1985 to 1993). In the meantime, Nigerians still wait in line for gas and import nearly 70% of their petroleum needs. In other words, Nigeria's oil earnings, which account for about 80% of the country's revenues, seem to do less to support the economy and feed the public than to enrich many of those in power (who immediately transfer their wealth to foreign banks).

Although not funded by USAID, another model for possible emulation in the ENI may be the Hong Kong Crime Commission (HKCC). This is an independent agency that reports directly to the Governor and operates completely independently from the police and the rest of the civil service. Basically, it serves as a public education mechanism and investigates alleged corruption activities (and exposes them to the public through hearings). The HKCC's findings and recommendations are then turned over to the Attorney General for possible prosecution.

## ANTI-CORRUPTION PROGRAMMATIC COUNTRY OPTIONS

### CIVIL SOCIETY PROGRAMS

- o nongovernmental watchdog/advocacy groups, civic monitoring organizations with hotlines, associations of professionals, businesses and users/providers of governmental services, self regulatory organizations, targeted cost/benefit analytical studies, and coalitions that mobilize business and labor groups as well as the media.
- o free and independent media, training for investigative journalists, ethical codes for journalists, international press centers, human rights organizations.
- o educational programs for businesses and citizens focused on the economic and political costs of corruption, how to participate in governmental programs, how to protect their property rights and public opinion polling.
- o national, regional and international workshops and conferences.

### GOVERNMENTAL PROGRAMS

- o transparent procedures and laws, freedom of information and financial disclosure laws, internal auditing laws and procedures, conflict of interest/ethical guidelines for executive, legislative and judicial branches, whistle blower protection programs, witness protection programs.
- o inspector generals, office of the ombudsman, auditor generals, independent anti-corruption commissions/committees, independent counsels, donor coordination mechanisms.
- o institution building programs related to the judiciary, the parliament, the procuracy, the law enforcement institutions and regulatory systems (capital markets, banking system), targeted islands of opportunity (tax police).
- o targeted civil service reforms including a salary scale above the minimum standard of living, incentives for reforms and rewards for honest officials, cost/benefit studies, performance based pay hikes, rotation of offices, modern management systems, and the appointment and dismissal procedures for judges, prosecutors and police.
- o laws and regulations clearly: defining corruption; protecting property rights; fairly punishing corrupt practices; enhancing inter-agency law enforcement coordination; outlining transparent and competitive procurement bidding procedures; mutual assistance treaties and regional/global cooperative mechanisms.

- o transparent and fair privatization of government assets, decentralization, reduction of import tariffs, tax reform and enforcement, financial reform and enforcement, demonopolization and trimming discretionary administrative and prosecutorial power, freeing of exchange rates, ending of price controls, development of a harmonized regulatory system of property rights, licensing, banking, taxes customs, credit and financial management.

- o national, regional and international workshops and conferences.

- o law enforcement programs designed for the police, prosecutors and judges should include drafting assistance to develop fair and effective laws to address specific corrupt practices, inter-agency/international coordination mechanisms and procedures, criminal law training, ethical codes and guidelines and human rights training.

David Satter  
 Senior Fellow, The Hudson Institute and  
 Visiting Scholar, The Johns Hopkins University Nitze School of  
 Advanced International Studies (SAIS)  
 October 7, 1999  
 House Committee on International Relations

### Statement on Corruption in Russia

Mr. Chairman:

The reports of massive Russian money laundering through the Bank of New York have awakened Americans to the victimization of the Russian people by their leaders and the possible consequences for the United States if corruption leads to Russia's social and political disintegration.

This newfound awareness, however, raises a disturbing question: How was it possible for the administration to depict the looting of Russia for so long as the progress of democracy and to back a coterie of corrupt Russian leaders whose actions were actually antithetical to reform?

The answer lies in the failure to understand that, in the wake of communism, Russia's greatest need was not a "correct" set of economic policies but rather the restoration of moral values which was only possible under conditions of the rule of law. By ignoring moral criteria and giving our uncritical backing to a group of leaders whom we identified as "reformers," we did not contribute to the welfare of Russia but only to its complete criminalization.

The following is a partial list of the events which should have alerted American policy makers that Russian reform was being carried out in a moral vacuum and the necessary role of the United States was to defend the rule of law.

*The Confiscation of Savings.* In January, 1992, prices in Russia were freed but no effort was made to index savings. The result was that in a few months, 99 per cent of the savings of the Russian population disappeared. Persons who had put money aside to buy a car or apartment or to pay for a wedding or funeral were left with nothing. Persons who had worked in remote areas of the country where a differential was paid on salaries were now stranded there, in many cases, for the rest of their lives.

*The Pyramid Schemes.* As the rate of inflation reached 2500%, fraudulent commercial banks and investment companies inundated Russians with advertising offering enormous returns on investment. The government made no effort to limit this advertising or to check on the firms which, in almost all cases were pyramid schemes, with the result that millions of people with no experience of deceptive advertising or capitalist investment, lost their savings a second time.

*Export Licenses.* The government began to allow anyone to export who could get a license. Because Russian raw materials were bought for rubles at internal prices and sold abroad for dollars, export licenses were akin to permission to print money. In Moscow, they were issued by the Ministry of Foreign Economic Ties, which functioned like a market, granting the licenses in return for bribes, with the fee for the license insignificant by comparison with the size of the bribe.

*Voucher Privatization.* In a move described as "people's capitalism," the government gave each Russian the right to acquire a voucher which was redeemable for a share in Russian industry. The vouchers, however, were of no help to individual Russians who had no say in management even when they invested their voucher in their own factory. They were useful to those who could acquire them in great numbers and criminal and commercial structures began to buy them up on the street and use them to purchase the most desirable factories, often at giveaway prices.

*Criminalization.* Criminal gangs saw that well connected insiders were using their ties to government officials to acquire vast, unearned wealth and began to use terror to take over their enterprises. One sign of this was the growing number of bankers and businessmen who fell victim to contract murders. Soon, however, gangsters, businessmen and corrupt officials began to work together. The gangsters needed the help of businessmen to manage large enterprises and the businessmen needed the gangsters to enforce contracts and collect debts. As the gangs prospered, bandits, businessmen and government officials developed close ties and, without any interference from the government, formed a single economic unit.

*The Abolition of Parliament.* Opposition in parliament led Yeltsin to rule by decree, which inspired the parliament to pass laws which nullified his initiatives. The conflict was finally settled when Yeltsin illegally dissolved the Supreme Soviet and, in the wake of a massacre outside the Ostankino television tower, persuaded the defense minister to authorize the shelling of the deputies who were still holed up in the parliament building. In a vote which is now believed to have been falsified, a new constitution was adopted that emasculated parliament and provided for the creation of an authoritarian, presidential regime.

*Money Privatization.* The government began to sell off Russia's enterprises for cash in auctions that were rigged in favor of whatever group was able to win favor with the local authorities and the state property committee. If, in a rare case, there was competitive bidding and a powerful group was outbid by an insistent competitor, the successful bidder could pay for his tenacity with his life. The result of this system was that enterprises were sold at absurdly reduced prices and the income raised from privatization in Russia from 1992 to 1996 was only 0.15 per cent of budget revenue although the government had sold off the industrial base of the country.

*Chechnya.* The government launched an invasion of the self proclaimed independent republic of Chechnya in hopes of having a "short, victorious war." Unable to defeat the Chechen resistance on the ground, the regime began the carpet bombing of civilian areas resulting in the heavy loss of life, particularly among Russian non-combatants. At the same time, more than 1,500 Chechen civilians were picked up by Russian interior ministry troops, taken to filtration camps and never heard from again.

*Nonpayment.* In 1993-94, the government began not paying for state orders and delaying payments on pensions and salaries for state employees. At the same time, banks entrusted with budgetary funds and enterprise directors began delaying payment on their obligations and depositing the money at interest in commercial banks. The result was that the nonpayment of salaries became Russia's leading source of social tension, subjecting individuals to intense strain and engendering a sense of total helplessness.

*Loans for Shares.* The government began to borrow money from commercial banks in return for shares in desirable, nonprivatized industries. In theory, the loans for shares program provided for competition for the shares. In practice, however, the winner was the bank with the closest "informal" ties to the government. Once an enterprise had been "mortgaged," the proprietary bank was free to exploit it. When the government failed to pay back the bank loans, which, given the state's revenue shortage was always the case, it was up to the bank holding the mortgage to organize the final sale of the enterprise. In all cases, the enterprise then became the property of the bank providing the original loan. In this way, the crown jewels of Russian industry were acquired for a song.

The attempt to transform Russian society without either moral criteria or the rule of law led to one of the gravest crises in Russia's history. In the resulting atmosphere of moral anarchy, the country was looted. The Russian gross domestic product fell by more than half. More important, Russia suffered a demographic catastrophe as male life expectancy in the period since 1990 fell by more than six years to 57, the lowest in the industrial world. Such a disaster befell Russia under peacetime conditions only twice before, in 1932-3 under conditions of famine and in 1937-8, at the height of the Stalinist terror.

In this situation, there was a historic role for the United States. With the fall of communism, the U.S., which at the time had overwhelming moral authority in Russia, could have insisted on moral practices and the strict rule of law, using two levers which would have been critical: political pressure and our influence over international loans. Instead, we used our power not to advance the rule of law but to promote the interests of a specific group.

It is often argued that the United States had no choice but to help Yeltsin because the alternative was to help the communists and nationalists who wanted to take his place. In fact, however, insisting on honesty and fair dealings from the reformers would have been the greatest favor that anyone could have done for them.

The reformers lost popularity in Russia not because they backed democracy but because they facilitated the criminalization of the country.

The answer now is to rethink our entire approach to Russia which must begin with an understanding of the moral vacuum that was left by communism. Only by recognizing that Russia's first requirement is a structure of law and morality that is valid for everyone can the groundwork be laid for real economic reforms capable of saving Russia from its present desperate situation. If we continue, however, to pretend that Russia is "on the path to reform" and Yeltsin and his confederates are the "embodiment of democracy," we may soon find that the growing desperation in Russia could produce a reaction capable of affecting not just Russia but the rest of the world as well.

**SOVEREIGN VENTURES**  
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**К О Р П О Р А Ц И Я**  
**С О В Е Р Е Й Н В Е Н Ч У Р З**

**HOUSE INTERNATIONAL RELATIONS COMMITTEE  
TESTIMONY BY  
MATTHEW H. MURRAY**

**PRESIDENT, SOVEREIGN VENTURES, INC.  
OCTOBER 7, 1999**

**“SMALL BUSINESS:  
A RESPONSE TO CORRUPTION IN RUSSIA”**

**HOLD FOR RELEASE: October 7, 1999 10:00 a.m.**

**FOR FURTHER INFORMATION, PLEASE CONTACT:**

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I have been professionally involved in Russian affairs for 20 years, as a legislative assistant in the Senate, a researcher at the Carnegie Endowment and Library of Congress, an attorney representing western corporations and an investor. Between 1992-1998, I lived in St. Petersburg and managed a number of business start-ups on behalf of the U.S. firm, Sovereign Ventures.

My dedication to earn profit for Sovereign Ventures on a legal basis has instilled a deep appreciation for the cultural barriers to small business in Russia. Other countries making the transition from a command economy, such as Poland and the Czech Republic, have succeeded in removing barriers. During Russia's transition, by contrast, small business has been severely regulated. The most mundane activities are subject to licensing and reporting requirements. Taxes are imposed not simply on profits, but also on revenues, the mere movement of capital and goods. A small business that challenges government authority risks sanctions and state interference.

The main element in Russian culture stifling entrepreneurs is the unrestrained role of government -- not only in regulating the economy, but also in profiting from the economy. Many officials in Russia have an expectation of financial reward for serving in public office. Many government positions are for sale and votes on legislation have an established market price.

During Russia's transition to capitalism, this expectation of reward has led to what economists call "rent-seeking". Rent-seeking is conducted by political elites in transitional economies who use their access to power to privatize state property spontaneously at nominal prices. As power-brokers, they convert their access to assets into cash by renting them to business. At times, rent-seeking takes the form of a demand for a bribe or extortion. Often, however, rent-seeking is quasi-legal, making it harder to detect.

The use of public position for private gain did not start with Perestroika or privatization. Nor can it be explained simply by Russia's low government salaries. To comprehend the phenomenon, you must first examine Russian history. Due to the absence of a strong idea of the state, government officials have traditionally been inclined and permitted to take care of their personal interests first. The Tsar's provincial representatives were expected to "feed themselves from official business". Under Soviet central planning, state resources were exploited by those with access to power, the members of the communist party, whose positions were bought and sold like commodities.

This government behavior takes place against a backdrop of public tolerance and weak institutions. Traditionally, Russian people have shown extreme dependency on the government and been reluctant to hold officials accountable. Currently, the Russian constitution provides Duma members immunity from prosecution. Russia lacks an independent judiciary capable of prosecuting government officials and an independent press capable of protecting their investigative journalists.



While Russia engages in privatization and other market reforms, official corruption adds a layer of rent on economic activity, increasing transaction costs for small business and the price of goods and services for consumers. By imposing an enormous number of different taxes and collecting them arbitrarily, the Russian government also extracts rent from small business.

Even tax reform designed to help small business yields new costs. For example, in 1995, Russia simplified the tax code for small business by eliminating all taxes in favor of a straight 10% tax on revenue, but left it to local legislators to decide how to implement the new reform. In St. Petersburg, they defeated the purpose by imposing a fee of up to \$8,500.00 per year on those businesses who wanted to use the simple tax. Foreign small businesses are effectively prohibited from using the simple tax, which is only available to companies with less than 25% foreign ownership.

I am pleased, therefore, to have the opportunity to appear before the House Committee on International Relations. At this time in debate over aid to Russia, there is consensus that the introduction of capitalism needs to be accompanied by the rule of law. But it would appear difficult to accept that the motivation for legal reform will not come from the Russian government. Historically, Russia's public officials have not relinquished their unilateral powers of interpretation and enforcement of the law. Currently, due to lack of resources and political will, the government is unable to enforce existing laws or adopt new legislation to protect small business and private property.

Instead, small business itself is the most effective agent for the type of social, legal and political reform sought in Russia. To date, Russia's market reforms have failed to produce a middle class. Small business can fill the "missing middle" by producing independent entrepreneurs with a vested interest in a stable and transparent legal system and the determination to hold government officials accountable.

To reduce official corruption, and otherwise sustain market reform, Russians must be empowered to remove all barriers to small business. Russia does not need western financial capital as much as it needs "social capital" – that is, the trust and shared values among individuals, businesses and government officials which are the very foundation of a successful market economy. Social capital accrues at the grassroots through the creation of voluntary organizations, such as business, trade and professional associations, rotary clubs, church groups, charities and non-governmental organizations. As small businesses must work together to break-down market barriers, they are a natural catalyst for the formation of such voluntary organizations.

Due to the special value Americans attach to small business and the rule of law, the United States has been acting to create social capital in Russia, by helping to build voluntary organizations, to reinforce traditional Russian ethics and to shape government institutions which are accountable. For example, in September 1998, the Eurasia Foundation, a non-governmental organization funded by the U.S. Agency for International Development, provided Sovereign Ventures an \$88,000.00 grant to begin a private sector initiative to promote business ethics. The Grant helped St. Petersburg

small businesses create the Declaration of Integrity in Business Conduct, a voluntary statement of commitment to international business principles and practices. Between June and September 1999, over 100 businesses voluntarily signed the Declaration of Integrity in Business Conduct. The Association of St. Petersburg Contractors, the St. Petersburg Chamber of Commerce and Industry, the St. Petersburg International Business Association, the American Chamber of Commerce and the St. Petersburg Rotary Club, which together have a combined membership of over 1,200 companies, have supported the Declaration and presented it to their memberships for signature. By adopting the Declaration, each company undertakes a no-bribery pledge and must implement a code of business ethics.

The Declaration is a small but critical step towards creating social capital among Russian businesses, business associations and non-governmental organizations in St. Petersburg. By empowering them to make a unified commitment to repudiate bribery, the Declaration potentially provides leverage to require the St. Petersburg government to take reciprocal actions to reduce opportunities for demanding bribes. The Governor of St. Petersburg's Council on Investment, an institution represented by both local government and private sector leaders, has already endorsed the Declaration. (The Declaration of Integrity in Business Conduct and a list of the signatories to the Declaration are attached for your reference.)

After a decade of rent-seeking capitalism, Russians must accept the fact that government corruption is endemic, an historical burden on economic and political modernization. Russians must find their own path to root out corruption, using the multitude of positive values and ethical traditions found in Russian culture. The St. Petersburg Declaration of Integrity is but one example of a process whereby Russians are beginning to integrate their strong moral traditions with international standards of business ethics.

Faced with the evidence of government corruption in Russia, many in the United States are shouting: "call the game". As though punishing this powerful nation will enable it to throw off a complex history. As though many other nations were not similarly infected by crony capitalism.

Instead, we should recognize that the process of rooting out corruption is long term and that Russians must find their own path towards this objective. Under these circumstances, it would be a mistake to isolate further the Russian people. On the contrary, the United States should seize upon the evidence of endemic corruption in government to increase aid directly to small business and micro-enterprises and the non-governmental organizations and business associations which are needed to lobby their interests. In the process, the U.S. can help Russian citizens prosper and form the social capital needed to protect individual private property from rent-seeking capitalists.

## DECLARATION OF INTEGRITY IN BUSINESS CONDUCT IN SAINT PETERSBURG, RUSSIA

Date:

### PRINCIPLES

The undersigned representative of the St. Petersburg business community ("Party to the Declaration") recognizes the following international principles of business conduct as the basis of this Declaration of Integrity in Business Conduct ("Declaration"):

**Transparency.** The functioning of a market economy presumes that each market participant conducts business with transparency, exchanging accurate information with other market participants on an efficient basis while respecting norms of confidentiality.

**Sanctity of Contracts.** Respect for the sanctity of contracts and the honoring of oral commitments leads to commercial ties built on good will, trust and reputation for honesty.

**Competition.** A competitive economy provides transparent rules and opportunities for market participants, rewards quality of performance and deters reproachable methods of obtaining advantages over other market participants.

**Repudiation of Corrupt Practices.** Corruption inflicts damage on market relations and on the economy as a whole. Repudiation of corruption as a method of business facilitates the process of stabilizing the market.

**Legal Settlement of Disputes.** A civil market presumes the rejection of illegal and dangerous methods to defend economic interests. Any use of violence against a person in a business dispute, including the use of physical or psychological coercion, is impermissible.

### DECLARATION

**NOW, THEREFORE,** in order to integrate the Declaration's principles fully into the business culture of St. Petersburg, by applying the principles consistently in concert with other members of the business community, each Party to the Declaration declares that:

#### ARTICLE I. CODE OF BUSINESS CONDUCT

- A. The Party to the Declaration has adopted or shall adopt a Code of Business Conduct based upon the principles set forth in this Declaration ("Code").

- B. The Party to the Declaration which has adopted a Code shall present the Secretary of the Governor of Saint Petersburg's Council on Investment («Depository») with a copy of the Code at the time of signing this Declaration.
- C. The Party to the Declaration which shall adopt a Code shall present the Depository with a copy of the Code as soon as practicable but no later than ninety (90) days after signing this Declaration. In order to ensure that the Code conforms with the principles set forth in this Declaration, each Party to this Declaration which shall adopt a Code can utilize the Model Code of Ethics in Business Conduct attached to this Declaration.
- D. The Party to the Declaration shall ensure that the Party's employees are familiar with the provisions of the Party's Code and systems of control that prevent actions by employees that are contrary to the provisions of the Party's Code.
- E. The Party to the Declaration shall present the Depository a letter affirming that the Party has faithfully conducted business in accordance with the Party's Code on an annual basis.

## ARTICLE II. PUBLICATION

- A. By signing the Declaration, the Party to this Declaration hereby agrees to be included on a Register of Parties to the Declaration ("Register"), which shall be maintained and publicized by the Depository. The Register shall include the name of the Party to the Declaration and the dates the Party's representatives signed this Declaration.
- B. The Depository shall update the Register regularly to include each new Party to the Declaration.

## ARTICLE III. MISCELLANEOUS

- A. The Party to the Declaration is signing and executing the Declaration voluntarily.
- B. Two duly authorized representatives of the Party to the Declaration shall sign and seal two (2) copies of this Declaration. One (1) copy shall remain with the Party to this Declaration and the second shall be submitted to the Depository.

For and on the behalf of \_\_\_\_\_

\_\_\_\_\_  
Company Stamp

# **SIGNATORIES TO THE DECLARATION OF INTEGRITY IN BUSINESS CONDUCT IN ST. PETERSBURG**

**September 10, 1999**

Westpost  
 Otis Elevators-St. Petersburg  
 KBE-Windows Technologies  
 "Sevzapmontagavtomatika" Group  
 Insurance Company "Interros-Soglasie"  
 Nonresidential Property Fund Consult (NF Consult)  
 ASTER  
 Business Initiative Center  
 Construction Group # 35 Igeorstroy  
 Insurance Company "Zurich-Rus"  
 Sovereign Property Holdings, LCC  
 Insurance Company "Alma"  
 LOVAL  
 Mitzar  
 Spetzrest #27  
 Construction Group 28  
 Building Group 42  
 Aqua Nord LTD  
 Delata Verona  
 Bronze Lion  
 Paris sur Neva  
 Diamond  
 MBC (International Water Service)  
 Group on Geodetic Work and Engineering Research  
 Construction Group 106  
 Reider  
 Mechanical Handling Consultants Limited  
 Technostrom-Construction  
 Thermoline Engineering  
 Transmachproect  
 AssiDomain Packaging St. Petersburg  
 Sindbad-Travel  
 VNIIGIDROLIZ  
 Rothmans-Nevo  
 Magline LTD  
 Mehzelestroy  
 LenStroyReconsrucziya  
 Containerships St. Petersburg  
 Travel agency Ekipage  
 Grand Europe Hotel  
 Neptune  
 Gloria  
 American House, Inc.  
 Tehlen  
 Geoizol  
 Advance-C  
 Sevenergostroy  
 StroyStekloComplect

**SIGNATORIES TO THE DECLARATION**

page two

Alla Fedotova Business-Service  
 LenSpetzMu  
 Alsim Alarko  
 Russian Initiative for Self Employment  
 Wakenhut Neva  
 Kelly Services  
 Eye Microsurgery  
 Lentek  
 Ladoga Foods  
 Arctika  
 Yit Yhtyma OYJ  
 Mechanical Group 260  
 Petro-Balt-Audit  
 Unipak Rus  
 JP Terasto (Jaakko Poyry)  
 Onninen St. Petersburg  
 KPMG  
 Marketing Consulting Design  
 Western-European Insurance Agency  
 KBC  
 AST  
 St. Petersburg Chamber of Commerce  
 Center for Citizen Initiatives  
 Honeywell  
 ESAB  
 Construction Company "Renaissance" (Vozrozhdenie)  
 AEROPROF  
 Eurovent  
 Insurance Company "Guide"  
 British Airways St. Petersburg  
 Nevski Institute on Language and Culture  
 DHL  
 Luch  
 UNISTO  
 DTZ  
 Nevskaya Medicine Company  
 Baltiyskaya Construction Company  
 Elf  
 Veho  
 Minimax  
 Military Insurance Company  
 Plastburg  
 Metrobor  
 Sovam Teleport  
 Norman DL Consultance  
 Henkel Era Tosno  
 Spezstroi Contractor Association  
 Borskoye Glass  
 NASTA-BALT  
 Structured Technologies  
 Lengazteplotroy  
 Kodeks  
 Gipronikel Institute

**Konstantin Borovoi**

**Deputy of the State Duma of the Russian Federation**

**October 7, 1999**

**House Committee on International Relations**

In the money laundering process, we have three very important stages. The first is the appearance of the dirty money from different sources (bribery, criminal money, mixed money). The second is the transferring and preliminary cleaning of this money. The third stage is the creation, with that money, of legal economic and political vehicles for the purpose of laundering more money or insuring the process. I will concentrate on the first stage because it is the subject of my research, announcements, official declarations and press conferences in Moscow.

1) Corruption in Russia is the result of a more complicated and widespread illness. Russia has ceased to be a democratic country and is very quickly transforming itself into a small and evil empire. This is very dangerous for itself, its citizens and for its neighbors. Corruption and the criminalization of power are only the outward appearances of a more general process.

2) What we now call the enormous size of corruption and criminalization in Russia was typical for Russia in the years 1995-96. Today, we have to speak about a new quality of that outward appearance. Now, corruption and criminalization have become the creative element of power, without which power cannot exist. To put it simply, it looks this way: if the government doesn't pay the parliament, they will not accept the budget and pass very important laws, for example, tax laws. If big companies, for example, oil or gas, stop paying the government they can disappear—they can be made to go bankrupt. This scheme is working at the state, region, city, district, and branch levels, even at the level of individual tax officials or small enterprises. The most dangerous thing is that this scheme is working very effectively and everybody has accepted it. The currency of payment can vary: cash—rubles or dollars; cheap credits; different privileges; additional support from the budget; support for the government during election campaigns, and so on.

3) Corruption and the criminalization of power may be the most important structural element of the system. It is starting to have an influence on the behavior of the whole system and on the motivations for Russian internal and foreign policy. How can the list of what should be in the armory be reconciled with what is actually there in reality? After some military official has sold weapons worth \$200 million dollars, the discrepancy can only be covered up by a real war, which is happening in Dagestan and in Chechnya. In the Georgian answer to some of the accusations by the Russian side, President Shevardnadze, with great wit, answered that Russian weapons for the Russian people for an internal Russian war can only come from Russian territory.

In Russian foreign policy we can see some decisions which are the result of blackmail to get more support from outside for "reform." It is quite clear that it happened during the process of NATO enlargement, when it was declared that including Poland is against Russian interests and can destroy the balance of the forces between Russia and the U.S.

Almost the same thing happened during the Yugoslav events. In 1998, from September through the summer, an unprecedented anti-Western and anti-American campaign was being spread. Russian military forces were planning military confrontation and military conflicts with NATO. In his official statements, Mr. Ivanov, the Russian Minister of Foreign Affairs, called the U.S. leadership military criminals. The Russian leadership unilaterally closed programs of cooperation with the U.S. while, at the same time, they distributed economic, political and military support to Milosevich and Saddam Hussein. Also at the same time, Mr. Primakov was very active in negotiations to gain financial support for Russia and credits from the IMF and World Bank. What was the U.S. leadership doing? Protesting? No. The proposal was to soften Moscow's position in exchange for financial support and credits. But, I would ask you, for what purpose? To make a new and stronger democratic system or a new aggressive empire? This is very dangerous for the world.

4) In 1991 the possibility for democratic development was created in Russia but the Soviet-type bureaucratic system wasn't destroyed. The military-oriented, inefficient plans weren't destroyed. And generally, a sort of competition started between the old economic and political system and the new rules of behavior and the newly appearing economic enterprises.

In 1992 it was quite clear to me what American policy in relation to Russia was—American financial support was directed at support of the Soviet type of power. And, in fact, it was supporting the old political system and old economy. At that time I was president of the biggest stock exchange and chairman of different banks and investment companies. Together with other big entrepreneurs and economic and political experts, we created a special report about our concerns on that subject. In that report we proved that support of the old system and the old economy would, in the near future:

- create enormous bribery in Russia;
- support Soviet and empire-oriented political forces; and
- create enormous difficulties for Russia's development.

Or, to put it simply, make it impossible for Russia to be a democratic country with a free market economy.

During my meetings with IMF, World Bank and U.S. administration officials, I tried to explain my concerns and our proposals for how to change actual conditions but, unfortunately, I didn't receive the reaction I expected. But the reaction, unfortunately, was very typical—such as my meeting with Mr. Strobe Talbott, who called me a person who doesn't believe in a democratic future for Russia and too economically liberal even on an American scale.



Not forgetting my position, I arranged that report like a statement for President Clinton, which was printed in the Russian media and sent through the American Embassy. At that time, the general position of the U.S. administration in relations with Russia was to create an environment for the self-development of democracy and a market economy in Russia. I would like to have seen someone try to propose the same way of creating democracy in post-war Germany in 1945. (In 1948, after the new German constitution was adopted, more than 70% of Germans were ready to support the return of the Nazi Party to power.)

5) The results of this mistaken strategy created some paradoxical situations in relations with Russia. Indirectly, taxpayers' money has now financed some projects in Cuba, Iraq, Iran and Belgrade. This is the strategy, by the way, that Primakov and Yeltsin called the creation of a "multi-polar world." With American taxpayers' money, they are now developing a new type of weapon and the means for its delivery.

And it is exactly with American taxpayer's money that they are arranging dirty, anti-humanitarian propaganda campaigns against NATO, the "faces of the Caucasus nationalities," the Baltic countries, and the United States. Now, for the first time since the Soviet era, in the minds of the Russian people, enemy number one is America. In April this year, the entire anti-American propaganda campaign—which was led by the Russian government—reached such a high level that 85% of the Russian population would be happy to support delivery of military volunteers and weapons, even S-300 anti-aircraft missile systems, to Milosevich. They would also support Russia's entering the war against America on the Milosevich side.

6) Even humanitarian and food support for Russia, which started in September 1998, is subject to the system's corruption and criminalization. In September 1998, I asked to meet with an American official who was responsible for delivering and distributing American aid and food support to Russia. I told him that the person responsible for connections with him, Vice Prime Minister Kulik, was not the right person for that type of activity. I gave him information that the food support, which had not yet appeared in Russia, was already stolen and could not effectively help the Russian population. And his answer was "Don't worry, we will watch everything and control everything. Nobody will steal even one grain." Two weeks ago, information that everything was stolen appeared in the media. I am telling you about this to explain how even American assistance and help can be discredited by the actual criminal situation in Russia.

#### What is to be done?

1) *Say good-bye to your illusions about Russia.* In Russia there is no democracy now. It's now only the illusion of democracy, a virtual democracy. We have to accept it and be more pragmatic, like doctors who cannot allow personal feelings.

2) *Good expertise.* A long term program for relations with Russia has to be created. Together with Mr. Kozyrev, the former Minister of Foreign Affairs, we created a

special institute for the problems of international cooperation. This institute started a special program for deeper research into:

- a) a long term prognosis for Russia's development in 50 years;
- b) project "Different Russia," which is especially for those who cannot understand the radical changes happening in Russia in the last three years;
- c) a realistic appraisal of the forces in Russia, which has to include a real accounting of the so-called KGB—or Primakov's—group, which has a great deal of influence now in Russia;
- d) accounting for the changes in the Russian people's mentality connected with the enormous propaganda campaigns in Russia in the last 5 years.

3) Any sort of mindless support to Russia which cannot be correctly checked and coordinated with the political goals of civilized societies must be immediately stopped.

4) *The most important thing is not to lose the pulse of Russia.* This means that everything stupid has to be excluded from relations with Russia but everything important for Russian democratic development must be saved and maybe developed.

We are ready to join that program and be useful to it and present our expertise in that field.

**U.S. House of Representatives: Committee on International Relations  
Hearing on U.S. Policy toward Russia, Part 2: Corruption in the Russian Government  
October 7, 1999**

**Statement of Lynn D. Nelson (Professor of Political Science and Sociology, Virginia Commonwealth University; formerly senior researcher, Institute of Sociology of the Russian Academy of Sciences)**

### **Overview**

Corruption, which was endemic to the Soviet system, has worsened in scope and magnitude within Russia since the demise of the Soviet Union and now is deeply embedded in the political and economic spheres at every level of Russian society. This development has been promoted through administrative-bureaucratic decision making at both the federal and regional levels which has reversed efforts toward broad democratization and facilitated widespread criminalization in the Russian economy.

The United States can support efforts to overcome corruption in Russia through clearheaded analysis of previous policy advice, with a view toward encouraging strategies in the future that more adequately emphasize institution building, the strengthening of civil society and the rule of law.

### **Soviet Era Roots of Corruption in Russia**

The organization and institutions of the Communist Party itself are deeply implicated in Russia's extreme problem with corruption and criminality today. A broad range of transactions in the USSR during the Soviet period had involved arrangements that were hidden from scrutiny and benefits that flowed from an individual's skill at operating outside the system of official rules. The Communist Party was the principal integrating structure in this system, legitimating and facilitating corrupt practices in many cases and also serving as a constraining influence on some of the more visible manifestations of self aggrandizement in the official economy. Further, under Gorbachev there was a conscious effort to legalize shadow economy initiatives in the hope of more efficiently using shadow capital to supplement the mainstream economy.

The Soviet economy had been built on the unchecked exploitation of both natural resources and human capital in the pursuit of objectives that were justified as being in the interest of all of society. With no institutions of civil society to evaluate or even effectively monitor these developments and progress toward these goals, corruption of a high order became routine.

### **Administrative Corruption in the 1990s**

With the end of the Soviet Union and the dominating influence of the Communist Party, powerful individuals in administrative positions finally achieved, with Yeltsin's

ascendancy and the Gaidar-Chubais economic program, objectives they had been seeking since before the Gorbachev period. They realized freedom from Communist Party control. Many gained ownership of vast amounts of property and resources. And they enjoyed these benefits in a context that would prevent competition. The institutional arrangements that had created Soviet departmental and regional "clans" were left largely intact below the top administrative levels of official power. These administrative-bureaucratic clans and their members became major beneficiaries of the Russian privatization program, effectively turning their positions, in the case of *nomenklatura* members, and their hidden capital and connections, in the case of many shadow economy participants, into legal property ownership and enhanced political power.

Official corruption in privatization and decision making more generally has taken many forms, from small scale bribe-taking and rent-seeking of various types, to bogus property auctions and high-stakes corruption in the issuing of "cheap" money from banks that were themselves often created through the privatization of Communist Party assets. A number of Russian businesses are closely tied to first-tier regional administrative elites and top-ranking former Party leaders who remain in positions of political authority. In these cases, interests depend heavily on the favor of officials for privileges and benefits that range from securing buildings and equipment to receiving necessary permits and licenses and being granted special tax consideration. These debts are paid not only in money but also in numerous other favors, such as lucrative jobs for relatives of officials.

### **Corruption and Economic Policy**

The nature of the Soviet era administrative system for ordering economic as well as political relations was well known when the Yeltsin reforms began. Procedures were needed that would have pointedly begun to reshape the established institutions of reciprocity and reward in which the socialist culture of the USSR had been grounded. Instead, however, the reformers chose to quickly graft private ownership onto the well-rooted economic arrangements that prevailed when the reforms were started. They also consciously decided to welcome illegally acquired capital and acknowledged that strategy.

This development, combined with the loss of Communist Party controls, has resulted in the expansion of criminality in mainstream economic relations. Criminalization of the economy has been further facilitated by the pattern of region-centered corporatism which prevails in many areas. Widespread rent seeking and diverse forms of economic exploitation are to be expected when both political and economic power are concentrated in the hands of regional authorities and many firms are thus prevented from becoming independent market participants.

### **Corruption in the Mainstream Economy**

A fundamental reason that criminality is so pervasive and deeply embedded in the Russian economy is that the shadow-criminal approach to economic relations transformed the mainstream economy, rather than being transformed by it. The

mainstream economy took on features of the shadow economy that have continued to develop and further crystallize during the 1990s. Not only was the money that these new business people used to acquire property often unlawfully gained, but "business" methods that they have frequently employed continue to be illegal in many cases -- ranging from bribery and extortion to murder. The criminalization of business is now thoroughly mainstream, to the extent that people expect, and get, illegality as an integral component of routine business activity. I have extensively documented this feature of the business environment through ongoing research in five Russian regions since the first days of the Yeltsin reforms.

In Russia today, market-like structures operate in an environment in which market principles are thwarted by administrative power, and entrepreneurship is hampered by the same administrative controls. At the time that the Soviet Union ceased to exist, the nonstate sector was developing rapidly. The number of cooperatives and private enterprises had grown dramatically from 1988 onward, and with these developments a new class of entrepreneurs had begun to emerge which promised, even before the breakup of the USSR, to pose a real challenge to the state economic monopoly.

In contrast to the positive developments under Gorbachev, the Yeltsin period has been characterized by policies that have inhibited the expansion of a supportive infrastructure for entrepreneurship. Although Yeltsin and many other political leaders continued to speak encouragingly about entrepreneurship, adequate measures were not forthcoming to put in place a comprehensive legal framework for market relations, for example, to create a workable system for financing business development, and to ensure tax policies that would provide adequate incentives for profit-making.

Respondents in my longitudinal research project have detailed a variety of tactics that state and local officials employ to use their positions for personal benefit. Entrepreneurs are often illegally charged for services of various types. They are required to pay fees that are not established and fined for infractions that are not proven. Entrepreneurs must rent their places of business, of course, and rents are often shockingly high -- frequently many times higher than official rates. Officials have, in some cases, set up their own enterprises while at the same time withholding sought-after business permits from potential competitors, and in other situations they have been found accepting bribes to funnel business development funds to certain business people and not others. These findings help to explain why, in spite of a reform program that ostensibly has been aimed at creating a free market, the expansion of legal entrepreneurship in Russia has been disappointing.

There clearly has been growth in the private sector since 1991, but a substantial proportion of it has been in the "gray area." This "gray area" entrepreneurship is a problem for the government, because tax revenues are forgone, and it discourages potential entrepreneurs who are unwilling to do business in this way. Because these "gray area" operations provide fertile soil for criminal activity, the forces that impede the development of new legal businesses produce undesirable outcomes for the entire society.

As a result of these and related developments, "reform" has tended to become a distinctively Western-sounding word for describing the changes in Russia's economy since the end of the Soviet period. From the remains of an economic system in disarray, the bureaucratic-industrial-financial alliance has solidified its power, using old connections and new money, acquired, in many cases, opportunistically. The Russian government continues to affirm its support for small business, but the predominant trend today is toward the consolidation of corporatism.

### **Corruption and the Reversal of Democratizing Reforms**

Relations in the political as well as the economic sphere have increasingly taken on negative features of the shadow-criminal sector because institutions which could have checked such a development have not been consistently encouraged. Russian reformers and Western advisers prominently attempted to discredit the legislative branch while supporting such executive abuses of power as Yeltsin's illegal moves in dissolving the Russian parliament in September and October 1993. During the time leading up to this crisis, a number of inaccurate and misleading statements were made about the composition and workings of the former Russian parliament in an effort to discredit the body as a whole. Prominent Western political leaders also were implicated in this process. Again and again, decree replaced legislative deliberation, and such circumvention of established procedures was justified on ostensibly pragmatic grounds.

While Yeltsin was consolidating executive power at the federal level, executives in Russia's regions were following the same script. At all levels, then, the last sources of authority were being systematically eliminated that could check administrative policy and privatization decision-making, which was increasingly carried out behind closed doors. Widespread abuses of power followed, with little organized resistance. Favorably-positioned former Communist Party elites successfully reasserted their strength -- now, as business people and executives presiding over clan structures. Those in power reaped windfall benefits through these maneuvers, and the Russian citizenry knew it.

These developments did not promote grass-roots democratization and the strengthening of civil society. The 1990s have seen a marked decline in the strength of democratically-oriented political groups that were the vanguard of change as the Communist Party was losing legitimacy during the late 1980s and early 1990s. Many who had advocated broad democratization and the building of institutions that would support market relations were forced to give ground to interests that supported strong administrative involvement over economic activity.

### **The Road Ahead**

It is widely understood that *incomplete liberalization* has brought on a sharp rise in corruption and criminality in the economic sphere and in Russian society more generally. What is less evident to a number of analysts, however, is why liberalization did not proceed as it had been envisioned by Russia's economic planners and their advisers from the West. They believed that the old institutional arrangements would somehow give way

under pressure from economic reforms, but that did not happen. It should not have been expected. The economic sphere does not operate independently of culture, and the economic levers on which the reformers depended were incapable of quickly overcoming the pervasive structural, politically grounded, impediments that were well entrenched.

Today, Russia's most serious crisis is a crisis of values. Many institutions of the old order remain in place, but without effective restraining principles to keep powerful interests in check, through shared reference to overarching values and "rules of the game." Today this crisis of values threatens destabilization in every sphere — economic, political and social. Effective support from the West during the current period must include focused concentration on ideas and practices in which we are experienced and which have been proven effective: an emphasis on law over the transitory appeal of individual leaders, and attention to liberal principles that ensure freedom in the economic, political and social spheres. Promotion of these core values, and of policies that encourage them, is the best way to confront the corruption in Russia that has become a defining feature of post-Communism in the 1990s.

Excerpt of Statement of J. Michael Waller  
 Vice President, American Foreign Policy Council  
 International Relations Committee Hearing on  
 U.S. Policy Toward Russia, Part I: Warnings and Dissent  
 October 6, 1999

*Pressure on AID contractors:*

"That expert, Professor Louise Shelley of the American University and a colleague of mine at *Demokratizatsiya* journal, had early evidence that organized criminal elements had exploited the U.S.-backed privatization program. In June 1994, ARD-Checchi Rule of Law project director David Bronheim sent an e-mail notice to offices in Moscow, Kiev and elsewhere with a warning about Dr. Shelly that appears to be intended to suppress and discredit her:

'I - Prof. Shelly. Please treat this with enormous care. If I had known what Shelly was up to, I would have resisted Henderson's instruction to put her on the consulting contract. She is a bomb with a lit fuse. Her hobby horse is that the AID privatization program has been exploited by organized crime.'

'1.1 The privatization program is the showpiece, flagship etc. of the AID program in Russia. Shelley, without understanding what she is doing, is trying to sink the flagship. Under no circumstances can we be seen as helping that effort. We have no interest whatsoever in damaging the centerpiece of the AID program in Russia.'

There you have it: as frank an admission possible that experts concerned with corruption of U.S. assistance programs were simply not welcome. A copy of the e-mail is attached."



FROM: David Bronheim, 73744,2306  
 TO: Moscow office (murphy), INTERNET:ard@ard1.law.msk.su  
 Dennis Whelan (1), INTERNET:whelan@whelan.law.msk.su  
 CC: Michael Goldstein (1), INTERNET:mg%ruleoflaw.kiev.ua@relay.ussr.eu.net  
 gregory goss, 73744,2323  
 Richard Hart (ARD), 73252,2335  
 Peter Maggs, 73744,2317  
 Hope Payne, 73203,373  
 DATE: 6/17/94 11:22 AM

Re: 94(2)db/13

94(2)db/M13

1- Prof. Shelley. Please treat this with enormous care. If I had known what Shelley was up to, I would have resisted Henderson's instruction to put her on consulting contract. She is a bomb with a lit fuse. Her hobby horse is that the AID privatisation program has been exploited by organised crime.

1.1. The privatisation program is the showpiece, flagship etc of the AID program in Russia. Shelley, without understanding what she is doing, is trying to sink the flagship. Under no circumstances can we be seen as helping that effort. We have no interest whatsoever in damaging the centerpiece of the AID program in Russia.

1.2. Reed must understand our position, and must realize we have a very nervous stomach about this. You will discover that this will make his stomach hurt as well. He will not want to be seen in USAID as someone involved with a program that might discredit AID. Please discuss this with him frankly.

1.3. Henderson will be in Moscow in ten days. Please encourage Reed to have the 3 of you talk this over.

2- Repeat of earlier question: How are you paying Watts for time after June 2 ???

3- ref yr dw\_dc.c june 10, para 1.b. It raises no problems at all to come back to USAID with more tech assist and less toys. We are only following their advice and adding more tech assistance. They will love it. (Have you in fact submitted to USAID a Work Plan and a draft MoU? Newton is away today, but I have seen neither. The only thing I am aware we submitted to AID was a design document. John says he left with you draft work plan and MoU documents, but nobody here has any awareness of a submission to USAID).

3.1. Again, the fact that we follow USAID's inclinations and develop our project along more satisfactory lines is something to be pleased about. We should be very upfront about this. We are making more headway than we anticipated.

3.2. Scholarships is a very difficult concept to administer. We can't do it directly, and to do it through the academy will be an administrative tangle - since they told us that it is the sending jurisdiction that pays for the student. It would be easier to pay lump sum to academy to cover the cost of a certain number of students if they tell us how students are selected, what the attendance is and what the courses are.

Opening Statement  
The Honorable Christopher H. Smith.  
House International Relations Committee Hearing  
October 7, 1999

Mr. Chairman, thank you for holding these hearings this week on U.S. policy toward Russia. The series of hearings that you have convened on Russia, and your leadership of this committee has been instrumental in increasing our knowledge of Russia and our relations with that nation. I believe it is especially important that the voices of our guests today be heard. In this connection, I would raise two points.

Mr. Chairman, about two months ago, after the press reported on an investigation of a New York City bank for possible Russian money laundering, Washington did its best Colonel Renault out of *Casablanca*, and was "shocked ... shocked" to find that there was corruption in Russia. The administration, when pressed, admitted that, yes, corruption was a problem. But it said everyone should "calm down," because we were getting our money's worth in terms of disarmament, democracy, and economic development, however uneven.

To tell Americans to "calm down," however, is patronizing and wrong. Eight years after the collapse of the USSR, many people in Russia blame America for supporting "reformers" and "reforms" that were associated with corruption that has robbed Russia of great wealth and left many people poorer. True, in the early 1990s reformers tried to rein in some of the worst corruption, but later their own reforms added to the problem. Too little reform, implemented too dishonestly has today left Russia crisis-ridden, unstable, and impoverished. Moscow's waging of a cruel and failed war in Chechnya is both a symptom and a cause of Russia's distress.

Now, the American people have a right to ask. Did not the Congress fund substantial assistance to Russia in the hope it would promote honest government and effective economic reform? Did not President Clinton and Vice President Gore meet often with Russian leaders and report that progress was being made? If so, what went wrong? And why are so many Russians down on reform and blaming America and the West?

As the *Washington Post* reported in an extensive article last month, the administration is trying to backtrack on its optimistic depictions and predictions for Russia. I look forward to our witnesses' comments on our Russia policy and how the administration responded to suggestions that all was not right in Russia, as well as our witnesses' thoughts on what effect U.S. policy may have for the upcoming parliamentary and presidential elections.

Let me add here, Mr. Chairman, that I am aware of the argument that for all its problems, Russia, and by extension, the United States, are much better off than we were during the Cold War era, that the United States spends large amounts of foreign aid on other nations that are corrupt, and that Russia is being held up to an unrealistic standard. I have some sympathy with that argument. I visited Russia this past summer, and I was there in 1988. The progress is obvious. But I have to ask: what was our contribution? Where did our taxpayers' money go? What happened to the investment opportunities that we heard so much about? Did our efforts help the Russians? Or did our efforts simply feed a kleptocracy that held back reform? In other words, have the Russian people progressed to the extent that they have *despite* our help, rather than because of it?

I am also deeply disturbed by the war currently going on in Chechnya. I know that the majority of people in neighboring Dagestan have been opposed to the incursions by guerrillas from Chechnya. The Russian government says it is fighting terrorism. If the United States Government can appropriately assist the Russian Government in apprehending through legal means the truly guilty parties in the explosions that took almost 300 lives in Russia, then I support that assistance.

But Mr. Chairman, the *Economist* has it exactly right: the logic of Russia's current actions in Chechnya is madness. And it is a malevolent madness, laying waste to land and killing innocent people whose only crime is to inhabit a lawless and desperately poor land. Ironically, until recently Moscow enjoyed considerable international sympathy in the current North Caucasus situation. Now it appears to be simply carrying out a war of vengeance against Chechnya and the Chechen people under the cover of dealing with the Dagestan incursion. It began with the long-running and intensified purge of so-called "dark people" in Moscow, and has now become another full-scale war against Chechnya itself. Like the Bourbons of old, Moscow appears to have learned nothing and forgotten nothing where the North Caucasus is concerned.

Moreover, Prime Minister Putin has announced that Moscow no longer recognizes President Maskhadov as President of Chechnya. Whatever we may say about the Maskhadov administration, one thing is clear. He was elected in free elections under the aegis of the OSCE with the approval of the Russian Federation as a result of the Khasavyurt Agreements. By distancing himself from the international community and acting like a communist leader of the old Soviet Union, Prime Minister Putin is taking Russia in the

wrong direction – toward militarism and authoritarianism. This is a path that bodes ill for Russia and the entire world. President Yeltsin should at least meet with President Maskhadov, and other legitimate spokespersons for the region, work toward a negotiated solution to the conflict – with outside assistance if necessary. For instance, the OSCE made a very constructive contribution to ending the bloodshed in Chechnya three years ago. This is certainly an avenue that should be considered.

Mr. Chairman, thank you again for holding these hearings. I look forward to hearing the testimony of our witnesses.





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