CHAPTER 4

RUSSIA'S ECONOMIC TRANSFORMATION*

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RUSSIA's postcommunist economic transformation stands out as one of the greatest changes in modern history. The Russian economic system has been profoundly transformed as the prior Soviet system has become a reasonably normal market economy. Not surprisingly, such a major conversion can be nothing but controversial, and the views of the transformation are highly varied.

To provide perspective, I start by summarizing these changes. The most fundamental transformation is that Russia has abandoned the Soviet command economy and adopted a market economy dominated by private enterprise. According to the European Bank for Reconstruction and Development (2010) about 65 percent of gross domestic product (GDP) is now produced in the private sector. After many years of rapid price increases, inflation has fallen to the single digit range. These were the three main goals of Russia's economic reformers: building a market economy, privatization, and macroeconomic stabilization. The purpose was to promote economic growth and welfare, and, indeed, from 1999 until 2008, the Russian economy grew by an impressive annual average of 7 percent.

However, the problems have been substantial. The costs of the transition were considerable and the economic output fell every year from 1989 until 1998, with 1997 as the sole relief. The official slump was as much as 40 percent, and although the real decline might have been lower (about 20 percent), it still has been quite dramatic (Åslund 2002, 118, 136). The dominant economic problem in the early transition was inflation that peaked at 2,500 percent in 1992. The expected problem of the nationwide unemployment did not really materialize, because real wages fell even at a faster rate. During the years 1989–94, male life expectancy fell drastically from sixty-four to fifty-eight years. During the same time, the crime rate doubled as the old order fell apart before a new one could be established. These indicators suggest that the greatest challenge was the disorder during transition. Due to political strife, the Russian reforms were much less comprehensive than in Poland and the Baltic states, but in Russia they proceeded much slower than the successful early and radical reforms in the other countries.

Today, the greatest remaining concern is the malfunctioning of the public sector because of its inefficiency and corruption. It is only a slight exaggeration to claim that Russia's reforms have essentially amounted to privatization, while the functioning of the public sector has barely improved and corruption has become much worse. Transparency International (2012) ranks Russia 133 among 176 countries on its corruption perception index. Prominent concerns are a widening gap in income and wealth and the persistently short life expectancy of Russian men.

Russia's economic structure has changed so profoundly that it is now similar to a modern Western economy. The biggest change is the contraction of manufacturing and the military-industrial complex and the expansion of the service sector. The Russian economy has opened up and become much more integrated into the global economy. The Soviet Union was a big importer of grain, but Russia has once again become a major grain exporter. What has not changed is the prominent role of raw material extraction, especially of oil and natural gas, which accounted for roughly one-fifth of GDP, two-thirds of exports, and half of the state revenues in 2010.

This overview of Russia's economic transformation begins with the examination of the causes of economic reform. The second section discusses Soviet economic reforms from 1985 and how they triggered economic collapse. The third section presents the reform program and its implementation. The final section assesses the outcome of the reforms.

Why Did Russia Launch Market Economic Reforms?

Not many places were as petrified as the Soviet Union in the early 1980s. The conventional wisdom was that the political and economic system was set in stone and would not change any time soon. Since the Russian Revolution of 1917, claims had been made that the system could never work, but nevertheless it survived. Occasionally, reforms had been undertaken, particularly in the 1920s, 1950s, and 1960s, but everything seemed to revert to the same (though less violent) old system, and economic growth continued at least officially.

The Soviet Union was never very wealthy or a social welfare state in the Western sense. Public pensions for all citizens were introduced as late as 1985. Yet the union could claim many achievements, the main one being that they were a superpower maintaining military parity with the United States. Since 1931, the Soviet Union insisted that it had abolished unemployment. Even if this was not completely true, it was not too farfetched. Another major accomplishment was a high level of education, particularly in mathematics, physics, and engineering. But the political pacification of the population gave rise to social problems such as demoralization, alienation, and apathy, breeding a widespread sense of social, cultural, and ecological decay. This demoralization aggravated a staggering alcoholism, which reduced male life expectancy beginning in the early 1970s. Rather than addressing those problems, the ever more gerontocratic administration of Leonid Brezhnev from 1964 to 1982 reacted by concealing bad news.

Many of the economic benefits in the 1970s accrued from the development of huge oil and gas fields in West Siberia and the very high level of international oil prices sustained from 1973 to 1980. In 1981, however, the world oil prices started a long-term decline, while in 1988 Soviet oil production and two years later the gas production reached their peak. The oil and gas bonanza was leveling off (Gaidar 2007), and because 90 percent of Soviet exports to the Western world consisted of oil and gas, their falling prices constituted a devastating blow to the Soviet economy.

The Soviet Union's crucial contradiction was that its economic growth was insufficient to sustain the country's military might. Officially, the Soviet annual economic growth rate was 3.2 percent in the first half of the 1980s, which corresponded to the annual increase in arms expenditure. But two iconoclastic Russian economists, Vasili Selyunin and Grigori Khanin (1987), calculated that in that period, Soviet real growth was merely at the stagnation rate of 0.6 percent a year. The root cause was that although the Soviet economic system was good at mobilizing resources, after mobilization the highly centralized system was unable to enhance efficiency.

Meanwhile, military expenditures rose at the cost of everything else. The U.S. Central Intelligence Agency (CIA) assessed that Soviet military expenditures increased steadily by 3 percent a year, and the agency gradually upgraded its estimate of the military share of Soviet gross national product (GNP) to 15–17 percent in 1987. The CIA overestimated Soviet GNP, so a share close to 25 percent of GNP seems to be more realistic (Åslund 1990; Bergson 1997).

The Soviet Union was also losing out in the budding information revolution. While the high-tech arms race was escalating and personal computers were spreading across the world, the Soviet Union resisted these developments because of technological conservatism, trade protectionism, and, most of all, a fear of free information flows. U.S. President Ronald Reagan's Strategic Defense Initiative (nicknamed Star Wars) might not have been that realistic, but it made the Soviet leaders acutely aware of their technological backwardness.

In December 1984, three months before becoming Secretary General of the Communist Party of the Soviet Union (CPSU), Mikhail Gorbachev (1987, 86) focused on the critical nexus of the arms race, insufficient economic growth, and technological backwardness; he formulated a goal of modernizing and recharging the Soviet economy: "Only an efficient, highly developed economy can reinforce [our] country's position on the international stage and allow it to enter the [next] millennium with dignity as a great and flourishing power."

Attempts at Economic Reform Speeding up Collapse

In hindsight, it is difficult to understand the early Soviet attempts at economic reform that started in 1985 after Gorbachev had become the leader. Many factors contributed to render these reforms quite inadequate.

A fundamental problem was the Soviet intellectual isolation. Neither the Soviet leaders nor their leading academics possessed relevant knowledge of the outside world. The communist ideology had prohibited access to modern economics and other social sciences, labeled "capitalist," and thus, by definition, wrong and misguided. Few in the Soviet elite spoke foreign languages, and no one in the Soviet Union had a Western doctorate in economics. Until 1990, Soviet leaders were not prepared to invite foreign experts, and the Soviet Union was not a member of such capitalist bodies as the International Monetary Fund (IMF), the World Bank, or the World Trade Organization. With little theoretical or empirical knowledge, Soviet leaders cooked up their own reforms, and the results were accordingly inadequate.

Communist dogma remained in force, and private ownership of the means of production and trade was condemned as speculation. Nor were the political elites convinced of the necessity, or even possibility, of reforms.

Initially, the political leadership was divided into two almost equally powerful wings, one that resisted all reforms as destabilizing or unnecessary, and another that was willing to contemplate some changes. The politics were further complicated as the "reformist" wing was split into three camps. One camp, led by Gorbachev, desired some kind of market socialism. A second camp, led by Second Party Secretary Yegor Ligachev, merely wanted to reinforce discipline. A third camp, headed by Prime Minister Nikolai Ryzhkov, opted for technocratic improvement of the old system. In effect, all three programs of change were pursued, but they were naturally laced with contradictions.

Political and ideological restrictions compelled Gorbachev to proceed with a rather erratic course of reforms. In 1985–86, with Ligachev's support, he launched campaigns against alcohol and unearned income, mostly generated by small, informal private enterprises. The antialcohol campaign led to a fall in alcohol sales by half and a corresponding drop of the important alcohol tax revenues. The campaign against unearned income inflicted a severe blow to legal small private entrepreneurs.

Later Gorbachev tried to accommodate the powerful state enterprise managers by giving them a wide-ranging autonomy through the Law on State Enterprises that came into force in January 1988. In effect, this law made it impossible to fire enterprise managers, leaving them accountable to no one. Increased investment and social expenditures were not financed by additional revenue and caused a budget deficit of 6 percent of GDP from 1986 onward. In 1988–89, the paramount problem was created by annual wage hikes that more than doubled as a consequence of that law.

The summer of 1990 offered the last opportunity to avert the Soviet economic collapse. The big event at this time was the elaboration of a major reform proposal, the 500-day program, by three young economists led by Grigory Yavlinsky. This was the first significant proposal to openly abandon a socialist economy and advocate privatization and a transition to a market economy. For some time, Gorbachev endorsed it, but after dismissing the proposal in October 1990, he sealed not only his own fate but the fate of his country and the Soviet economic system.

In early 1990, all of the fifteen union republics had more or less democratic elections, which led half of them to want to leave the Soviet Union. The federal finances fell apart and toward the end of 1990, the Soviet macroeconomic crisis turned wild, helped by the populist social policy of the Congress of People's Deputies. This body suddenly decided to raise social benefits by 25 percent, in competition with the Russian legislature, and in 1991 in Russia those benefits surged by a staggering 81 percent (Goskomstat 1996, 116). Wage increases continued to accelerate, and they skyrocketed by 97 percent in 1991 (Goskomstat 1996, 116).

In 1991, state finances broke down even further. Although the statistics are sketchy because the Soviet accounts for 1991 were never completed, the union revenues collapsed and the budget deficit jumped to an estimated 31 percent of GDP (EBRD 1994). Soviet foreign debts were not all that large, but the government refused to deal with them until the country had run out of all foreign currency reserves and defaulted. Most prices were still controlled, which led to severe shortages for most goods. As enterprises no longer could acquire inputs, their output started plummeting. When the Soviet Union collapsed in late 1991, the economy was in free fall, with GDP falling by 15 percent (UN Economic Commission for Europe 1992, 105), while prices were rising even in presence of price regulation.

To sum up, the underlying cause of the collapse of the Soviet economic system was its inability to raise its efficiency and resist the series of outside shocks that eventually broke the system. One shock was the rapidly rising costs brought by the arms race with the United States and the rising information technology revolution in the West. Another shock was brought by financial factors, excessive domestic budget deficits, and monetary emission, leading to overwhelming shortages and foreign debt. A third problem was the inadequate way reforms were undertaken, leading to an acutely dysfunctional system with massive fiscal deficit. A fourth blow was a sudden change in the volume of oil rents because of falling world oil prices.

The reforms that had been undertaken appeared rather accidental at the time, but in fact they were driven by the strongest vested interest—the state enterprise managers. A perfect rent-generating machine had been constructed. The partial liberalization of foreign trade allowed a limited number of state enterprises to carry out arbitrage between low state-controlled domestic prices of raw materials and high world market prices and between greatly varied exchange rates. The Law on State Enterprises permitted enterprises to keep the remaining profits, which had previously been confiscated by the state at the end of a year. New cooperatives that were in fact private enterprises allowed enterprise managers to transfer the profits of their state enterprises to their private companies. New commercial banks provided them with cheap state credits to finance their businesses.

When the Soviet political system collapsed in 1991, many state enterprise managers, not real democrats themselves, came out in favor of Russian President Boris Yeltsin, which further enhanced their public standing. Their dominant interests were driven by economics, and their desire to become owners of the state enterprises they managed. Although this group of managers favored market economic reforms, they preferred slow reforms that allowed maximal privileges. Those included buying commodities at low state-controlled prices and selling them abroad at free market prices that sometimes were 100 times higher than the state's ones. In fact, the managers opted for slow insider privatization.

The Reform Program

Yeltsin had been elected president of Russia on June 12, 1991, with a solid popular majority of 57 percent, but only the abortive hard-line coup in August 1991 made him the real president of Russia. His political support appeared overwhelming at the time, so Yeltsin concentrated on two tasks: dissolving the Soviet Union (a task he implemented in December 1991) and salvaging the Russian economy from abject crisis.

The economic decisions were entirely in Yeltsin's hands, as he was the only authority with the full democratic legitimacy. After two months of deliberations after the coup, on October 28, 1991, Yeltsin made his greatest speech to the Russian Congress of People's Deputies:

> I appeal to you at one of the most critical moments in Russia's history. Right now it will be decided what kind of country Russia will be in the coming years and decades.... I turn to you with determination to stand unconditionally on the road of profound reforms with support from the whole population.... The time has come to act decisively, firmly, without hesitation.... The period of moving with small steps is over.... A big reformist breakthrough is necessary. (Yeltsin 1991)

Yeltsin declared that the two central economic tasks were to establish economic freedom and financial stabilization:

> We have a unique opportunity to stabilize the economy within several months and to start the process of recovery. We have defended political freedom. Now we have to give the people economic [freedom], remove all barriers to the freedom of enterprises and entrepreneurship, offer the people possibilities to work and receive as much as they earn, after having relieved them of bureaucratic pressures. (Yeltsin 1991)

He emphasized the need for an instant liberalization of prices, macroeconomic stabilization, and privatization, providing a reasonable amount of detail. The Russian parliament, which had elected Yeltsin its chairman only in the third round of voting in May

1990, received his speech with rousing applause. Cleverly, Yeltsin put his programmatic speech for radical economic reform to a vote, and the deputies voted 876 to 16 in favor (Aron 2000, 491). He had received a nearly unanimous parliamentary mandate.

Yeltsin elaborated on his choice of economic reform strategy, taking into account the inconsistency of prior Soviet and Russian reforms: "Russia's trouble was never a shortage or an abundance of reformers. The trouble was an inability to adhere to a consistent policy.... Not a single reform effort in Russia has ever been completed.... The goal I have set before the government is to make reform irreversible" (Yeltsin 1994, 145–47). He (1994, 150) acknowledged the depth of the economic crisis, and by fall 1991, "the rationing of virtually everything had reached its limit. The shelves in the stores were absolutely bare."

His chief economic adviser, Yegor Gaidar (1999, 114), justified his choice of early price deregulation: "There *were* no reserves to ease the hardships that would be caused by setting the economic mechanism in motion. Putting off liberalization of the economy until low structural reforms could be enacted was impossible. Two or three more months of such passivity and we would have economic and political catastrophe, total collapse, and a civil war."

The main inspiration of the Gaidar strategy was the radical economic reforms of Poland in 1990 and Czechoslovakia in 1991. Russia appeared set to repeat their reforms with a concentration of major reform measures in a "big bang" in January 1992. As the macroeconomic crisis deepened in late 1991, the reformers became more radical and opted for a more concentrated big bang. Both Yeltsin and Gaidar used the phrase "shock therapy," although their actual approach to reform was somewhat partial. The reforms came with absence of desired concentration and comprehension, which was difficult to avoid in the post-Soviet chaos.

Yeltsin's next step was the formation of a new government, which was equally daring and innovative. He decided to put the government in the hands of Russia's best economists: "When forming the government, we discard the priority of political considerations to the benefit of professionals" (Yeltsin 1991). "It was high time to bring in an economist with his own original concept, possibly with his own team of people. Determined action was long overdue in the economy, not just in politics" (Yeltsin 1994, 124).

His reform speech was largely drafted by Gaidar, arguably the best and most erudite Russian economist. He had set up his own Institute of Economic Policy in Moscow, where he had gathered the best of Russia's young economists with its sister institute in St. Petersburg. Yeltsin quickly made Gaidar's economic team his new government. However, Yeltsin (1994, 125) considered it impossible to have a thirty-five-year-old nonpolitician confirmed as head of the government by the Russian parliament. Over November 6–8, 1991, Gaidar became deputy prime minister as well as minister of Finance and Economy. Yeltsin made himself prime minister, and his chief political aide Gennady Burbulis his first deputy. A group of young reformists, whose ages were between thirty-five and forty, took over major portfolios in the government, with the most prominent of them, Anatoly Chubais, receiving the post of minister of privatization.

Gaidar's new ministers were professional economists with doctoral degrees. They knew English and had studied mainstream Western economics, although largely on their own. They were the most intelligent and well-educated children of the foremost intellectual *nomenklatura*. The Soviet Union had cut itself off from the world to such an extent that none of them had earned a degree abroad. One of the young reformers, Sergei Vasiliev (1999, 86), characterized their team: "A group of professional economists, the Gaidar team, had some understanding of the situation and proposed a more or less adequate approach to handling the economic challenges at hand. No other group of economists was able to come up with a comprehensive program." Their dilemma was that they were highly elitist and distant from the population. They undermined their credibility by proudly calling themselves a kamikaze government.

Yeltsin's government was structured in a very different way from Soviet times. Whereas the old Soviet government had a dozen deputy prime ministers and almost a hundred ministers, Yeltsin's new Western-style government consisted of only three deputy prime ministers and twenty-three ministers. The many industrial ministries were abolished. The State Planning Committee (Gosplan) was renamed the Ministry of Economy and deprived of most of its old functions. As in a typical capitalist government, the Ministry of Finance became the dominant ministry. The main innovation was the creation of the State Property Committee, which was, in fact, a ministry of privatization. Over time, several branch ministries were reinstated. The number of ministers steadily increased, as did the number of deputy prime ministers, but the new type of government persisted.

Deregulation and Macroeconomic Stabilization

The early reforms consisted of two major elements: deregulation of prices and trade and macroeconomic stabilization. Gaidar led the charge with intelligence and determination, and 1992 started, as intended, with a big bang. His two main policies were radical price liberalization and balancing the consolidated state budget. The long-awaited price liberalization took place as announced on January 2. Everybody expected that the huge monetary overhang would lead to a massive price increase. Official prices rose instantly by about 250 percent, far more than the 100 percent the government had expected, but no public protests were reported. A major reason was that the population was fed up with shortages, and free market prices were already very high. Free market prices rose much less and to a large extent extended preexisting inflation in free markets. Another reason was the realization that the Soviet economic system had stopped functioning. Moreover, the price liberalization did not appear to target any particular group but changed the existing economic paradigm. Gradually, shortages diminished. A market economy of sorts was born.

The reformers attempted to liberalize foreign trade, unify the exchange rate, adjust it to the market, and make the ruble convertible. However, their endeavors were impeded by the complete depletion of Russia's currency reserves and the subsequent extremely low exchange rate of the ruble. In December 1991, the Russian average wage was as low as $6 a month at the free exchange rate. Still, imports were almost completely deregulated because of the widespread desire to end shortages. Exports, however, remained regulated by licenses and quotas because the prices of oil and natural gas, Russia's main exports, were regulated at the level far below world market prices. The government could do little but introduce a complex system of surrender requirements for exporters to tax them somewhat and make sure they repatriated their earnings. Two serious problems emerged. One was export control for commodity exports, and the other was the lingering state trade within the Commonwealth of Independent States (Michalopoulos and Drebentsov 1997).

Gaidar's second major challenge after price liberalization was balancing the consolidated state budget. He focused on two major cuts while trying to maintain a high level of revenues. First, the price liberalization instantly eliminated large price subsidies. His second big strike was against military procurement, which he initially slashed by 85 percent and eventually leveled the cuts at 70 percent. For the rest, he tried to keep state subsidies and public investment low. Initially, Gaidar had amazing success, turning a budget deficit of 31 percent of GDP in 1991 to a slight budget surplus on cash basis of 0.9 percent in the first quarter of 1992.

The price liberalization and fiscal tightening put the Central Bank of Russia under extraordinary pressure. The monetary overhang was eliminated, and the real money supply shrank by two-thirds, from 77 percent to 25 percent of GDP.[1] On November 22, 1991, the reformers suffered their first serious defeat in the parliament when the government's request for control over the Central Bank was rejected. Instead, Ruslan Khasbulatov, the speaker of the parliament, supervised the Central Bank, and he turned against radical market reform. By the second quarter of 1992, the Central Bank expanded the credit volume, and with a change of leadership in the summer of 1992, the monetary discipline fell apart. Russia came close to hyperinflation.

Another problem that made hyperinflation almost inevitable was the persistence of the common ruble zone. In early 1992, no fewer than fifteen mutually independent central banks issued credits in the same currency. If one country issued more credits than the average, it reaped a disproportionately larger share of the common GDP, but the more credits were issued, the higher inflation was. This was the ultimate moral hazard. The three Baltic states broke out in the summer of 1992 and managed to stabilize their economies, but all the other states stayed in until various times in 1993, when ten of the twelve post-Soviet republics experienced hyperinflation of more than 50 percent for at least a month. In the fall of 1993, the ruble zone was broken up and a basic precondition for financial stabilization was established.

In effect, Gaidar succeeded in liberalizing most prices and thus introduced a rudimentary market economy. He managed to abolish most price subsidies and dealt a devastating blow to the military-industrial complex that has never recovered.

Macroeconomic stabilization, though, was elusive until the financial crash of August 1998. The IMF program of 1995 had led to the control of inflation, but this cure was unbalanced. It relied on a very strict monetary policy and substantial external financing, rather than a significant reduction of the fiscal deficit. The fundamental problem was that Russia maintained an average budget deficit of 8–9 percent of GDP from 1993 until 1998. A World

Bank study by Pinto et al. (2000) estimated that total Russian budget subsidies amounted to a staggering 16.3 percent of GDP in 1998, of which 10.4 percent of GDP was extracted through barter and nonpayments and 5.9 percent amounted to direct enterprise subsidies. To a surprising extent, the budget deficit was financed with foreign portfolio investment, which skyrocketed from respectable \$8.9 billion in 1996 to incredible \$45.6 billion in 1997, or 10 percent of GDP (Russian European Centre for Economic Policy 1999).

By late 1997, everything came to a crunch. The Russian government had boosted the budget deficit, and much of the tax revenues were in offset rather than money. About half of all interenterprise payments were made in barter, about a quarter in money surrogates, and only a quarter in money (*Russian Economic Barometer* 2004). In the fall of 1997, the Asian financial crisis erupted, and the previously ample global liquidity suddenly dried up. At the same time, the global oil price halved from an already low level. Belatedly, the new Russian government opted for a big new IMF program, but it was too late. In July 1998, the Russian State Duma refuted several of the revenue measures demanded by the IMF, and the IMF let Russia fail.

On August 17, 1998, the Russian government defaulted on its domestic treasury bills, devalued the currency—eventually by three-quarters—and froze international bank payments for three months. The latter in effect created the total freeze of bank accounts. Once again, ordinary Russian bank savers lost their money, usually about two-thirds of their deposits, and they had to wait in humiliating lines outside the banks for days hoping to rescue some of their savings. About half the Russian banks collapsed. Inflation that had fallen to the single digits surged to 85 percent for 1998 as a whole. The Russian stock market hit bottom with a staggering fall of 93 percent from its peak in October 1997 to early October 1998. Remarkably, in 1998 output fell only by 4.6 percent.

Surprisingly, the Russian financial crash made it possible for Russia to finally boom. The complete lack of financing forced even a not very reformist government to eliminate the budget deficit. The public expenditures were cut drastically by 14 percent of GDP from 1997 to 2000. The main cuts hit enterprise subsidies and pensions. A second wave of substantial structural reform occurred in 1998–2002, which was the beginning of Russia's great decade of an average economic growth at the 7 percent level. The oil prices recovered somewhat in 1999, but it was only at the end of 2003 that they took off, rising to over \$30 per barrel.

Privatization

By necessity, privatization started in a gradual manner and was preceded by the most multifaceted and intense debate. The essence of the privatization policy boiled down to three objectives: speed and volume, political acceptance, and the creation of millions of private enterprises, analyzed by Andrei Shleifer, Anatoly Chubais, and others (Boycko, Shleifer, and Vishny 1995; Chubais 1999; Shleifer 2005).

The easiest task was to sell off small enterprises. In February 1992, the first shops were auctioned off. Small-scale privatization gained full speed in July 1992, and an average of 5,000 to 6,000 small firms were sold each month until July 1993. By August 1994, the government estimated that no fewer than 106,000 small firms had been privatized. The government moved quickly by holding several auctions, where most shops were sold cheaply to their managers, thus facilitating fast privatization.

The big question was how to privatize the all-dominant large public enterprises. Between 1989 and 1991, a plethora of associations, concerns, and corporations were set up as ministerial officials attempted nomenklatura privatization. By the end of 1991, Russia harbored more than 3,000 such associations. After extensive debates and negotiations, the government managed to persuade the Russian parliament to amend the Privatization Law and adopt a Privatization Program in June 1992. In August 1992, Yeltsin made privatization the centerpiece of his speech on the anniversary of the coup. He advocated the benefits of capitalism for ordinary people: "We need millions of owners rather than a handful of millionaires." He emphasized equality of opportunity and freedom of choice. The big news was that Russia would undertake a voucher privatization: "The privatization voucher is a ticket for each of us to a free economy."[2] The inspiration for voucher privatization came from Czechoslovakia.

The first voucher auctions were held in December 1992, and the last took place in the summer of 1994. Meanwhile, 16,500 large enterprises (each with more than 1,000 workers) had been privatized in this way. This was the largest privatization the world had ever seen. The distribution of shares, however, did not quite go as expected. Only 20 percent of the shares of the companies were actually sold at voucher auctions, largely to outsiders, whereas by 1996 18 percent of the stocks were owned by managers and 40 percent by workers, with managers often controlling their employees' shares. A critical mass of private enterprise had been built, with Russia claiming 920,000 private enterprises in 1995 (Blasi, Kroumova, and Kruse 1997, 189, 192–93). In effect, although the Russian mass privatization was an insider privatization, the voucher aspect of it confirmed that real private property rights had been introduced. According to the EBRD (1997), by 1996 no less than 70 percent of Russia's GDP originated in the private sector. Capitalism had arrived.

On the negative side, privatization became so unpopular that President Vladimir Putin could turn the tide from 2003 and start a wave of renationalization through lawless confiscation and financially dubious purchases by inefficient state corporations of efficient private enterprises.

Assessment of the Outcome of the Russian Economic Reforms

The assessments of the Russian transformation from a command economy to a market economy are highly contradictory and are likely to remain so. This is all too natural because this was a truly momentous metamorphosis with many causes and outcomes. Today, the universal view is that Poland, the Czech Republic, and the Baltic states have been much more successful in their market reforms in the past two decades than Russia has. I share that view, but it is important to understand wherein the differences lie. I would emphasize five big differences in the reforms: preconditions, how radical and comprehensive the reforms were, democracy, oil, and Western policy.

First, Russia faced far more difficult preconditions. The Soviet system had lasted for seventy-four years, versus only for forty-five years in Eastern Europe. As a consequence, prices and economic structures were much more distorted in the Soviet Union. There was no precommunist commercial legislation and little private enterprise existed. The Soviet economy was in an extraordinary and multifaceted crisis during its last year and a half. Radical reformers claim that this was a terminal crisis of the old system and that the only sensible act was to abandon it as soon as possible and move to a market economic system. Gradual reformers, on the other hand, downplay the Soviet economic crisis in 1991. They claim that it could have been mitigated within the traditional framework and that the cause of the very high inflation in 1992–93 was not the inherited financial crisis but the "shock therapy" with the sudden deregulation of prices in January 1992.

Second, the successful reforms in Poland, the Czech Republic, and the Baltic states were, according to the annual EBRD *Transition Reports,* more radical and comprehensive than in Russia, whereas a common popular view considers Russia's economic reforms very radical (e.g., Stiglitz 2002). Evidently, confusion reigns. To the popular mind, disorderly or disruptive reform equals "radical," whereas economists tend to rank a reform "radical" by how far-reaching it was. Many observers of Russia seem unaware that the label "shock therapy" was first applied to the planned reforms in Poland in 1989, long before the Russian reforms were contemplated (Gomulka 1989). The reforms in Central Europe and the Baltics were completed much faster than they were in Russia, so the economy was not left in disruption and dysfunction for long; in Russia, elementary macroeconomic stabilization was completed only by 1999.

The reformers in the government failed to assume control over the Central Bank of Russia, which proceeded with issuing money at such a speed that no monetary stabilization was feasible. The inflationary ruble zone persisted until fall 1993. The government failed to hold the budget constraints against the populist parliamentarians and state enterprise managers until 1999.

Third, Russia failed to undertake an early systematic democratic reform in 1991–92, when it was possible. The threat to the market reforms did not come from the population but from vested interests, such as state enterprise managers in the early transition, later oligarchs, and state officials thriving on corruption. Those groups wanted some market reforms, but they opted for slow ones that allowed them to thrive on privileged arbitrate between state-controlled and free prices (Fish 2005). As a consequence, Russia has not been very successful in its institutional reforms. The critics of radical reform claim that the reformers ignored institutions. The reformers' response is that the Russian parliament resisted market economic institutional reform from June 1992 until December 1999, the period when antireformist or rent-seeking objectives prevailed.

Yeltsin focused on the dissolution of the Soviet Union and economic reform but left political reform for a later period. In his memoirs, Yeltsin (1994, 127) examined his strategy: "Maybe I was in fact mistaken in choosing an attack on the economic front as the chief direction, leaving government reorganization to perpetual compromises and political games," he wrote. "I did not disperse the Congress.... Out of inertia, I continued to perceive the Supreme Soviet as a legislative body that was developing the legal basis for reform. I did not note that the very Congress was being co-opted. The deputies suddenly realized their omnipotence, and an endless bargaining process ensued.... But the painful measures proposed by Gaidar, as I saw it, required calm—not new social upheavals." Unfortunately, Yeltsin did not alter this decision until September 1993, when it was too late. This was a major mistake, arguably the greatest of his career. As a consequence, his government's economic reforms suffered. "Without political backup, Gaidar's reforms were left hanging in midair," Yeltsin wrote.

Fourth, oil and other natural resource rents have offered Russia's rulers great temptations to opt for easy personal enrichment rather than reforms beneficial to all, as emphasized by Gaidar (2007). Reforms were initiated in the mid-1980s, when oil prices fell to a new low, and in 1998 while another low was reached. In 2003, international oil prices took off, and the already prepared reforms were put aside as their implementation was delayed. A widespread view is that Russia can reform only if the world oil price is low.

Finally, Western policy was of profound importance. The biggest sin of omission rests with the West, in particular U.S. President George H. W. Bush. In October 1991, Yeltsin exhorted Western governments publicly and at length to help Russia with technical and financial support, but his call was ignored. Only five months later, Yeltsin received an answer of sorts from Bush and German Chancellor Helmut Kohl, but it was never substantiated, and by that time the Russian reformers were already battered by the parliament's relentless attacks, led by Khasbulatov and Vice President Alexander Rutskoi. The demonstrative absence of Western support contributed to the fall of the Russian reform government and the failure to control inflation. Unlike Poland, Russia received no international financial support for its market reforms in the course of the first year of attempted reform.

This was a key difference between the former Soviet Union and Central Europe. Poland obtained the necessary financial support early on and a large debt reduction. It was offered an extensive access to the European market and was given European membership perspectives. Poland was the forerunner for the rest of Central Europe, which received necessary Western support and entered the right track from the outset. Russia, however, was offered nothing but kind words that soon turned out to be empty. The other former Soviet republics, witnessing how the West ignored Russia, lost all hope for successful early reform.

It is an undeniable fact that Russia is a very corrupt country. The critics of radical reform blame corruption on privatization and how it was carried out (notably, Stiglitz 2002, chapter 5). The advocates behind Russia's privatization, on the contrary, blame the rise of corruption on the gradual nature of deregulation of the Russian economy, which bred lasting rent seeking or corruption (Boycko 1991; Murphy, Shleifer, and Vishny 1993). To them, privatization was a means of containing corruption (Kaufmann and Siegelbaum 1996).

The ultimate confusion concerns the 1990s versus the 2000s. It is indisputable that the economy contracted in the 1990s and grew substantially from 1999 to 2008. The popular Russian view has become that the growth has arisen because of the political stability of Putin's reign as president and prime minister. Reformers, by contrast, argue that cause must precede effect, and in the case of a major and prolonged systemic change, the reform has to be reasonably complete before it can be effective. To the reformers, the explanation of the growth from 1999 is the liberalization of prices and trade and privatization in the 1990s, the macroeconomic stabilization prompted by the financial crash of 1998, and the structural reforms of 1999–2002. In addition, international oil prices took off in 2003.

Two decades after the start of postcommunist reform, it is pretty obvious what has been achieved and what has failed. Russia's level of economic development has advanced quite impressively. At present, its GDP per capita is roughly the same as in Poland and the three Baltic states. The big difference between Russia and the more successful reformers lies in governance. By all measurements, Russia is far more corrupt than Central Europe and the Baltics, and politically it is authoritarian. This is true of most former Soviet republics. Russia's key problem is the malfunctioning of the state, which is reflected in everything from traffic jams, due to failure of extending the road networks, to low male life expectancy.

Notes

* Unless stated otherwise, an overall reference to this article is my book, Åslund (2007). The literature on Russia's transition is huge, but few works offer both overview and detail. Other major works on Russia's economic transition are Åslund (1995), Mau and Starodubrovskaya (2001), Sutela (2003), and Shleifer (2005). Two fundamental sources for the early transition are the memoirs by Yeltsin (1994) and Gaidar (1999). The key book on Russian privatization is Boycko, Shleifer, and Vishny (1995). Among sharp critiques of the Russian economic reforms, Goldman (2003) and Rosefielde and Hedlund (2008) may be singled out.

1. Government of the Russian Federation, *Russian Economic Trends* 2, no. 4 (1993): 116.
2. Boris Yeltsin, "The President's Address to the Citizens," *Rossiiskaya gazeta*, August 20, 1992.

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