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## Conclusions: Why Market Reform Succeeded and Democracy Failed

As President Vladimir Putin's second term is drawing to a close, Russia is a market economy but no democracy. How did Russia end up in this situation, and how is it likely to develop?

Russia experienced a great revolution, which had many implications for its development. The revolution was carried out from above. It was formed by Russia's three consecutive leaders and their ideas. As shown in chapter 3, the empirical evidence suggests that early, radical, and comprehensive reforms worked best. Privatization was always controversial, and assessments have changed over time. At present, the respect for the resulting property rights seems crucial, which means that the political acceptance of privatization is key. Our investigation of Russia's policymaking in the last two decades leads to general conclusions on how policymaking is best done in the midst of a revolution. This is also a suitable occasion to review the role of the West in the Russian transformation.

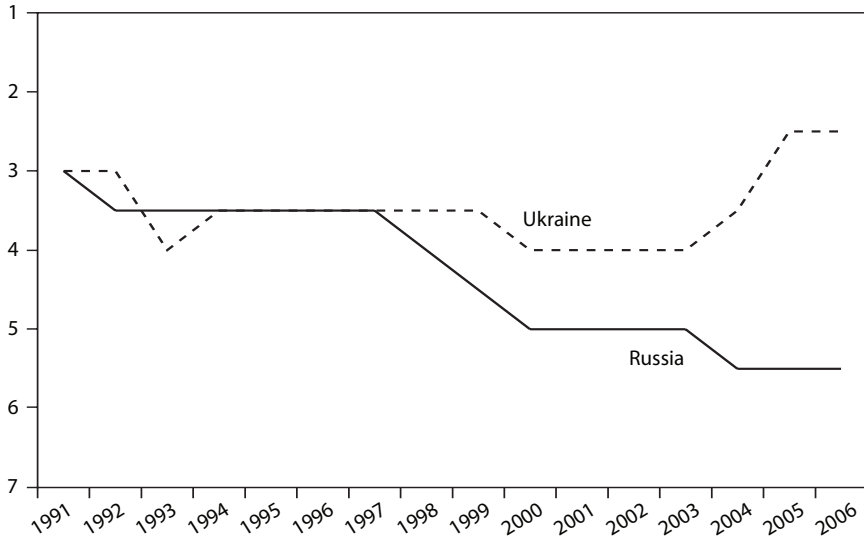
Finally, we turn to Russia's future. Currently, the dominant picture is a contradiction between market economic success and reactionary politics. This disparity is widening with Russia's economic growth, and its politics are becoming increasingly authoritarian. This contradiction is not likely to last for long. Either authoritarianism or the free economy will have to give, and the obsolete political system is more likely to lose out.

### Market Economy but No Democracy

The empirical evidence is strong: Russia has persistently grown less democratic since 1992, while it became a market economy after a couple of years of transition, with no significant reversal.

**Figure 8.1 Civil and political rights in Russia and Ukraine, 1991–2006**

index (from 1 = free to 7 = not free)



Source: Freedom House, *Freedom in the World Historical Rankings*, <http://freedomhouse.org> (accessed on May 28, 2007).

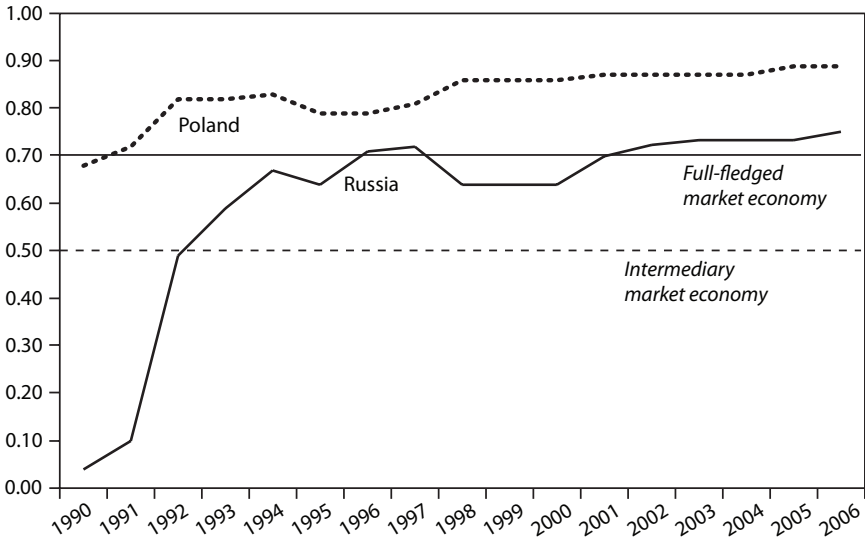
A country's degree of democracy, or civil and political rights, is authoritatively assessed by Freedom House (figure 8.1). It rated Russia as "partially free" from 1992 to 2003 and "not free" from 2004. Russia's political freedom has steadily deteriorated from 1992, when the country was close to free, to its present state of mild authoritarianism. Russia can be compared with Ukraine, which was similarly semidemocratic in the 1990s, but Ukraine did not suffer Russia's authoritarian degeneration in the late 1990s. Ukraine's freedom increased greatly after the Orange Revolution in late 2004.

The most relevant measure of a country's degree of market economy is the EBRD's transition index, ranking countries from no market economy (0) to normal Western market economy (1). From 1992 to 1995, Russia was an intermediary market economy, in the interval 0.5–0.7, and in 1996 it reached 0.7, the level of a full-fledged market economy. Figure 8.2 includes Poland for comparison. Its more far-reaching reforms are representative of Central Europe and the Baltics. Russia's rise was sufficiently sharp to qualify it among the countries that undertook "early, radical economic reform" from 1991 to 1993 (Åslund 2007a, 84–86).

The key feature of a market economy, according to the definition in the introduction, is that economic decisions are predominantly made by free

**Figure 8.2 EBRD transition index, 1990–2006**

index (0 = no market economy, 1 = free market economy)



EBRD = European Bank for Reconstruction and Development

Notes: The formula of this index is 0.3 times EBRD's index for price liberalization and competition policy, 0.3 times EBRD's index for trade and foreign exchange liberalization, and 0.4 times EBRD's index for large-scale privatization, small-scale privatization, and banking reform. Thus this index represents liberalization to 73 percent, while the rest is privatization.

Sources: De Melo et al. (1997); Havrylyshyn and Wolf (2001); author's calculations from EBRD (1998, 1999, 2006).

individuals and independent firms. Russia's distribution is completely private and independent. No state planning committee tells enterprises what to produce. Nor does the state allocate goods. Prices and trade are predominantly free, and Russia's subsidies are small. Transactions are overwhelmingly monetized. All perceivable financial markets have evolved (Frye 2000).

The private sector is predominant, contributing 65 percent of GDP according to EBRD (2006) (figure 7.2). Russia has 5 million registered private enterprises (figure 6.9). Its stock market capitalization has reached \$1 trillion, equaling its GDP, as is common in Western Europe. The World Bank and International Finance Corporation (2006) *Doing Business* index ranks Russia as 96th among 175 countries, that is, average. Russia receives its best rankings for enforcing contracts (25), starting a business (33), and registering property (44), which all concern property rights, while the regulatory environment is bad. Russian companies take the state and one another to court ever more often (Hendley 2002, 2004). Russia's negotiations on World

Trade Organization (WTO) accession clarify the problems. Subsidies have raised limited concerns, whereas regulations and intrusive state inspections are the dominant issues. The final proof of Russia's status as a market economy is that since 2004, the European Union and the United States recognize Russia as such according to exceedingly strict legal criteria.

Concerns about the oligarchs' domination of the Russian economy appear exaggerated. They do not own that large a share of the economy and they face severe market competition. Oligarchs dominate large-scale industry, primarily energy and metals, but in energy they are increasingly squeezed out by the state. Russia's industrial sector is still large by international standards, contributing 38 percent of GDP in 2005, compared with 27 percent of GDP in the euro area (World Bank 2007).<sup>1</sup> Currently, the state accounts for 85 percent of gas production and 55 percent of oil production. The approximately 30 oligarchic groups probably contribute about one-quarter of total GDP together. The biggest oligarchic sector is the steel industry with six major companies, and commercially more consolidation is needed. The production of a few metals—aluminum, nickel, and copper—is nearly monopolized, but these industries face strong international competition. Only in gas and aluminum are Russian corporations among the biggest in the world, and Gazprom is controlled by the state.

The threat of the state is greater, as the state is expanding its ownership through renationalization. Yet, many factors contain its expansion. The state tends to enter industries that are growing slowly, such as gas and oil, and state ownership depresses production growth further. Russia has no socialist ideology.

At present, Russia's big state corporations are moving from full state ownership toward 51 percent state ownership. Two major state companies—Rosneft and VTB—made initial public offerings (IPOs) in 2006 and 2007, respectively, to move in that direction. As a result, state-dominated corporations are exposing themselves to assessment by the stock market.

Although privatization has slowed down, it continues. Russia's power industry is being divided up and privatized. Some state forays into complicated industries, such as the automotive industry, are bound to result in spectacular failure and be reprivatized in the near future. Many officials want to transform their power into private fortunes, which they do through transactions, some of which are nationalizations, while others are privatizations.

Given that Russia's economic freedom holds firm, while its political freedom is declining, the disparity between them is rising. In 2004, Shleifer and Treisman (2004, 22) published a provocative article in *Foreign Affairs*, arguing that Russia was a "normal country":

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1. Partly, Russia's large industry reflects insufficient market adjustment, and the industrial share in Russia's GDP should shrink further. Partly it shows Russia's comparative advantage in raw material-extracting industry.

Russia was in 1990, and is today, a middle-income country with GDP per capita . . . comparable to Argentina in 1991 and Mexico in 1999. Almost all democracies in this income range are rough around the edges: their governments suffer from corruption, their judiciaries are politicized, and their press is almost never entirely free. They have high income inequality, concentrated corporate ownership, and turbulent macroeconomic performance. In all these regards, Russia is quite normal.

Their assessment rang true at the time, but the imbalance between economic and political freedom has grown worse over time, because of Russia's backsliding to authoritarianism. For the last decade, the world as a whole has become more democratic, while Russia's economic strength has grown substantially.

One excellent attempt to explain why Russia has failed to democratize is *Democracy Derailed in Russia* by Steven Fish (2005). On the basis of multi-country regression analysis, he singled out three causes: "too much oil, too little economic liberalization, and too weak a national legislature" (p. 247). First, Russia's abundance of raw materials has undermined democratization by fueling corruption and encouraging economic statism. Second, the "predatory regulatory environment has slowed the growth of an entrepreneurial class and the middle class more generally. . . . It has left society underorganized, inarticulate, and incapable of holding rulers accountable" (p. 248). Third, Fish argued that the imbalance between the presidential might and the limited powers of the legislature "damaged the legitimacy of the post-Soviet regime," "inhibited the development of political parties," and undermined state capacity (pp. 248–50). The unconstrained presidential power also stimulated corruption.

While Fish looked upon Russia in the aggregate, Kathryn Stoner-Weiss (2006) undertook an empirical study of why regional democratization failed in Russia. She found that the limitations of market reform impeded regional democratization, as local businessmen colluded with regional governors to thrive on corrupt revenues. Stunted party development weakened the linkage between the federal government and the regional governments (p. 112). With weak parties in the regions, clientelism evolved instead of institutions, and it encouraged corruption. Russia entered a vicious circle. Businessmen paid huge amounts to buy the elections of regional governors because they could benefit so much (p. 146).

Both Fish and Stoner-Weiss argue that authoritarianism benefits corruption, and therefore the beneficiaries of corruption favor authoritarianism. Apart from Fish's emphasis on the corrosive impact of oil, they do not offer any reason for Russia not becoming democratic in the longer term, if marketization and economic growth proceed.

## Russia's Capitalist Revolution

The Soviet collapse and Russia's post-Soviet transformation from 1985 to 2007 become comprehensible only if we realize that this country went through a revolution. Revolutions have many peculiar features in common.

As early as 1984, Richard Pipes (1984, 50–51) considered the Soviet situation revolutionary, because the ruling elite could no longer rule, and the population did not accept to be ruled in the old way. In July 1986, Mikhail Gorbachev revealed that a revolution was under way: “I would equate the word perestroika with revolution.”<sup>2</sup> Boris Yeltsin was intensely conscious of being part of a revolution and contemplated its logic at each step (Yeltsin 1994).

Since Russia experienced the Great Socialist Revolution in 1917, Russians were acutely aware of what revolutions were and how they functioned.<sup>3</sup> Major actors understood and used the revolutionary momentum, but sometimes they refused to accept revolutionary precedents. In particular, a broad consensus opposed the bloodshed and civil war of the 1917 revolution, which rendered Russia’s capitalist revolution so peaceful.<sup>4</sup>

The literature on revolutions is immense. A major classic is Crane Brinton’s (1938/1965) *The Anatomy of Revolution*. It analyzed four successful revolutions, the English revolution of the 1640s, the American revolution, the great French revolution, and the Russian revolution of 1917. Brinton established a chronology of revolutions: first stages, the rule of the moderates, the rise of the extremists, reigns of terror and virtue, and Thermidor (postrevolutionary stabilization). The literature on Russia’s 1991 revolution is extensive.<sup>5</sup>

A schematic revolutionary paradigm frames the Russian development from 1985 to 2007 perfectly well. Mau and Starodubrovskaya (2001, 330–32) offer a stylized process of revolution, which guides the structure of this book. Gorbachev was the liberal reformer who inadvertently unleashed the revolution. Yeltsin was the revolutionary hero, who did not quite know what to do after the revolution, and Putin became the postrevolutionary dictator, a Napoleon or Stalin, who consolidated power in authoritarian rule when people had grown tired of politics.

When Gorbachev, the moderate revolutionary, came to power, both the elite and the population harbored a solid contempt for the old regime. It lacked legitimacy and Marxism-Leninism was a dead idea. People were passive, but only because they thought change was impossible. Gorbachev lit their hopes, and glasnost enlightened Russians about their relative economic backwardness. His early attempts at economic reform failed because of resistance from the party elite. The new party leadership became

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2. *Pravda*, August 2, 1986.

3. In Soviet historiography, it is called the second Russian revolution, the first being the abortive revolution of 1905.

4. A theorist of revolution, Chalmers Johnson (1982, 7), has argued that a “nonviolent revolution” is “a contradiction in terms” (quoted in McFaul 2006, 191).

5. Three excellent sources are McFaul (2001), Mau and Starodubrovskaya (2001), and Aron (2000).

increasingly divided, with a profound rift erupting between the three leaders Gorbachev, Yeltsin, and Ligachev in November 1987. Their split represented a characteristic revolutionary divide between moderates, radicals, and reactionaries.

As Alexis de Tocqueville (1856/1955) observed on the time before the French revolution, old injustices became more intolerable. "For it is not always when things are going from bad to worse that revolutions break out. On the contrary, it oftener happens that when a people which has put up with an oppressive rule over a long period without protest suddenly finds the government relaxing its pressure it takes up arms against it" (p. 176). "Only consummate statecraft can enable a King to save his throne when after a long spell of oppressive rule he sets to improve the lot of his subjects" (p. 177).

The rule of Gorbachev's reform communists from 1988 to 1991 was characterized by impressive political liberalization, but it also drove radicalization and polarization, because a broad public realized that the Soviet system could not be reformed, only broken or conserved. The old institutions were too rigid to adjust to new demands, rendering revolution the natural outcome (Bunce 1999). Gorbachev, the reformer, stayed in a vanishing political center, being outflanked by both the liberal revolutionary Yeltsin and reactionary communists. The liberal intelligentsia and reformist enterprise managers joined Yeltsin, who was the master of radicalization and democratization. Because of the inadequacy of Soviet economic theory and strong pressures from rent-seeking interests, Gorbachev's reforms transformed the Soviet economic system into a rent-seeking machine that broke down the economy. In 1991, the Soviet Union had become ungovernable and the state collapsed.

The failed August 1991 coup delivered the revolutionary breakthrough, and Yeltsin assumed power. He dissolved the Soviet Union, making Russia somewhat manageable, and he launched a radical market economic reform. The liberal revolutionaries built new market economic institutions and started redistributing property from the state to the new elite, but the economic crisis was too deep to allow quick results. Political reform was left on the back burner, while society calmed down.

The radical reformers were split and became alienated from more moderate parts of the elite. First enterprise managers and then oligarchs seized power, as the revolution turned more moderate, and the redistribution of property to these new elites continued. The ideas of the market economic revolution were already taken for granted, signifying the ultimate success of the revolution: "when great revolutions are successful their causes cease to exist and the very fact of their success has made them incomprehensible" (de Tocqueville 1856/1955, 5).

Finally, a postrevolutionary dictatorship was established after Putin came to power. The economic reforms had succeeded, and people were happy to enhance their personal welfare. They were tired of politics and

withdrew, allowing Putin to consolidate authoritarian power. Almost as suddenly as the state had collapsed, it came together again, which the population greeted with relief.

If we accept that a generalized revolutionary scheme fits the Russian transformation, several important observations follow:

- First, a revolution has its own internal logic that is not exclusive to any nation. In the last two decades, Russia's development has followed a normal revolutionary logic, and national peculiarities have been secondary.
- Second, a characteristic of a revolution is that the institutions of the old regime fall apart or stop functioning for some time. As a consequence, state failure has been greater than market failure (Shleifer 1997, Shleifer and Vishny 1998).
- Third, in the near absence of institutions, the latitude and impact of political leaders become all the greater. They can carry out much more profound changes than usual, as long as they understand the limits of administrative capacity.
- Fourth, during the period of radicalization, moderation is not an option. Russia's problem was not that the reforms were too radical, but that some key reforms, notably political reforms, were not undertaken during the short revolutionary window of opportunity.

The main achievements of Russia's capitalist revolution were the peaceful dissolution of the Soviet Union, the building of market economic institutions, and privatization. They were secured during the short window of opportunity that was at hand. The problem with Russia's democracy building was that no clear idea existed. Therefore, the period of extraordinary politics was not exploited. Since democratic institutions were never properly built, they could not withstand the postrevolutionary reaction.

The revolutionary dynamic delineates the main stream of events, but the determinism must not be exaggerated. Each leader had a great deal of leeway. One of the peculiarities of this Russian revolution was that it was antirevolutionary, as was the democratic revolution in Eastern Europe in 1989, being directed against the socialist revolution of 1917 (Dahrendorf 1990). The revolutionaries did not long for utopia but for "a normal society," which meant a wealthy Western European society.

Through their reaction against the Russian revolution of 1917, a broad Russian consensus refuted the use of force and bloodshed. Revolutions have often led to war, but so far Russia's capitalist revolution has avoided that fate even if Russian statements are growing increasingly aggressive. Another reaction against 1917 was Yeltsin's conviction that the Soviet administration must not be dissolved and that lustration of old cadres was

harmful. He wanted to avoid the Soviet classification of people as “class enemies.” The 1991 revolution was not only antisocialist but also anti-ideological. Gaidar and Chubais were attacked for being too ideological and called “market Bolsheviks,” mostly by communists who favored status quo, but they claimed to be technocrats and professional economists. This strong resistance against ideologies was an impediment not only to clear thinking and consistency but also to fanaticism.

Nearly everything that was identified with 1917 or the CPSU was condemned. The communists had always been rash, which made many praise gradualism or even slowness. The long-lasting dominance of the CPSU engendered a widespread dislike of political parties among all but orthodox communists, leaving the Communist Party as the only sizable political party.

## **Russia’s History Is That of Its Leaders and Their Ideas**

In two books about Soviet and Russian leaders, George Breslauer (1982, 2002) described a three-stage pattern of their rise, consolidation of power, and decline. He emphasized the importance of the leaders in Soviet/Russian politics, showing their extraordinary freedom of choice. This means that Soviet institutions were less of a straitjacket than is usually thought, particularly in this revolutionary time, when institutions and social forces were so weak.

Revolutions are times of ideas. The ideas of the leaders were extremely important and were to mold their policies, which John Maynard Keynes’s (1936/1973, 383–84) noticed:

the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. . . . I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas.

Political scientists, by contrast, often emphasize the restrictions imposed on policymaking by institutions and interest groups. An excellent example is Daniel Treisman’s (1999–2000) article “After Yeltsin Comes . . . Yeltsin.” Treisman argued: “The undesirable aspects of Russian politics and policies in the 1990s have resulted less from the bad decisions made by powerful central leaders . . . than from these leaders’ extreme impotence” (p. 75). He foresaw that Yeltsin’s unnamed successor would be as constrained by regional governors and oligarchs as Yeltsin had been and predicted that Russia would “remain a decentralized federation” (p. 83). Treisman’s daring but incorrect prediction illuminates two theses. First, during the Russian capitalist revolution, the leader and his views were far more important than institutions. Second, during the postrevolutionary

stabilization the leader could defeat strong interest groups with the re-assembled state institutions.

Gorbachev was a nice man who wanted to do good. He embraced the ideas of enlightenment, modernization, and internationalization. But his ideas were quite vague, which is evident from his memoirs (Gorbachev 1995). Gorbachev accomplished what he understood.

- Glasnost was his and Aleksandr Yakovlev's original contribution. The Soviet Union and the world were astounded by how fast and radically these two men broke down the age-old Soviet censorship. The freedom of speech and media that lasted in Russia from 1989 to 2000 was their accomplishment.
- Gorbachev loved foreign policy, and he concluded three important arms control agreements: INF in 1987, CFE in 1990, and START I in 1991. He also engineered the Soviet exit from Afghanistan.
- The Soviet evacuation from Eastern Europe and the reunification of Germany were Gorbachev's greatest international accomplishments. Sooner or later, the Soviet Union would probably have been forced to depart because of imperial overstretch, but the timing and the peacefulness were to Gorbachev's credit.

Gorbachev tried to introduce democratization, market reform, and federal reform, but he did not think clearly about any of these topics. Therefore, his confused actions unleashed the collapse of the Soviet political system, the Soviet economic system, and the Soviet Union.

Yeltsin and Gorbachev were the same age, and they came from the same kind of background and made similar careers, but they could not have been more different as persons. Yeltsin was a rebel and revolutionary, who was prepared to think and do the unthinkable. Although he was less close to intellectuals than Gorbachev, he was more interested in ideas. He shifted between manic periods and depressions when he drank heavily, and his drinking and illnesses stifled his reign. Yeltsin's high point was 1989–91, before and at the beginning of his tenure as Russia's president.

- By standing in elections in 1989, 1990, and 1991, and each time winning a resounding democratic victory, Yeltsin cemented democratic elections in Russia.
- On January 13–14, 1991, Yeltsin shamed Gorbachev to stop the bloodshed in Vilnius and Riga. He went to Estonia to meet with the Baltic presidents and signed a declaration for the Baltic nations' independence together with them. He issued an appeal of his own to the Russian soldiers in the Baltic republics, urging them to abstain from violence, securing the independence of the Baltic States (Aron 2007, 15–27).

- Yeltsin's most heroic deed was Russia's democratic breakthrough. He faced down the August 1991 coup, proving himself an outstanding revolutionary leader. His calmness, strength, and confidence inspired Russians to stand up for their rights as citizens.
- The prohibition of the CPSU immediately after the coup gave the democratic revolution a chance before the revanche of the old regime. Gorbachev and Yeltsin did this together, but Yeltsin was the driving force.
- Yeltsin's greatest achievement was to dissolve the Soviet Union easily and without bloodshed, in opposition to Gorbachev. He chose the optimal time, one week after Ukraine's referendum on independence, and he acted with the necessary speed, attaining a clear break of the no longer tenable union.
- Yeltsin's last great accomplishment was the radical economic reform he instigated in October 1991. Together with his economic reformers, Yeltsin built a market economy faster than anybody had dared to hope. He delegated most decisions to his young economic reform ministers.
- Gaidar successfully deregulated prices and imports.
- Gaidar also defeated the military-industrial complex through a draconian cut of arms procurement.
- Chubais succeeded in executing both a small-scale privatization and a large-scale mass privatization with vouchers.

Yeltsin was the revolutionary hero. The problem, however, was that he remained president until 2000, and he did not attain much positive after 1993. His greatest sin of omission was that he did not disband the old parliament early enough to avoid the bloodshed of October 1993 and thus failed to consolidate Russia's democracy.

Yeltsin made two major mistakes. First, he launched the first war in Chechnya in December 1994, which was brutal, costly, and unnecessary. Yeltsin's final mistake was to appoint Putin as his successor.

Putin is the opposite of Gorbachev and Yeltsin. He belongs to the cynical Brezhnev generation, while Gorbachev and Yeltsin came of age under Khrushchev's thaw. He comes from an NKVD family background, whereas Gorbachev and Yeltsin had family members who had been repressed by the NKVD. Putin made his career in the KGB, not in the party, and he was a near failure. Gorbachev and Yeltsin knew little about the West although they shared its values. Putin knows the West well and speaks German and English, but he detests Western values. Gorbachev and Yeltsin favored democracy, but Putin opposes it. Both Gorbachev and Yeltsin were revolutionaries, but Putin is a restorer. The only common denominator among these three men is that they all understood the need for a market economy.

- Putin should be recognized for one important achievement, the completion of the market reforms that he carried out in his first term.
- His main endeavor, however, has been a systematic centralization of authoritarian power in his own hands and a far-reaching deinstitutionalization.
- His first targets were the regional governors, whose power he eliminated.
- Next he minimized and marginalized independent media.
- Finally, he defeated the oligarchs through the confiscation of Yukos and the jailing of Khodorkovsky.

The rest was little but a mopping up operation. In its period of postrevolutionary stabilization, Russia was susceptible to an authoritarian reversal, but it was not a given. The authoritarian restoration was Putin's choice. He is an outstanding image maker. He has made the Russians feel good and proud of themselves, Russia, and its history again. Unlike Gorbachev and Yeltsin, he maintains a great popularity toward the end of his second term.

Naturally, the political leaders did not decide everything themselves, but when they focused on a goal, the effect was truly amazing.

## Early, Radical, and Comprehensive Reforms Most Effective

In this book, a large number of attempts at reform have been discussed. It is easy to classify them as radical and gradual. To an extraordinary extent, radical reforms have been successful, while gradual reforms have failed.

Among the radical reforms, many stand out: the dissolution of the Soviet Union, price deregulation, import liberalization, unification of the exchange rate, cuts in military procurement, small-scale privatization, voucher privatization, the fiscal adjustment of 1995, and the cleansing of the financial system in 1998. By and large, every reform that was sufficiently radical succeeded in the sense that it achieved the intended results, was completed, and was not reversed.

The opposite can be said about gradual reforms. Invariably, they have failed. Four important examples are: the early monetary policy, the preservation of the ruble zone, the slow deregulation of energy prices, and the tardy democratization.

First, CBR Chairman Georgy Matiukhin's "moderate" monetary stabilization with an average expansion of M2 of 11 percent a month in the first five months of 1992 left everybody dissatisfied. No hard budget con-

straint or demand barrier was erected to force enterprises to restructure. Nor was output stimulated.

Second, the gradual dissolution of the ruble zone was a full-fledged disaster. All the dozen central banks within the ruble zone had strong incentives to issue more money to seize a disproportionate share of the common output. The defenders of the ruble zone argued that adjustment must be gradual and that fast change was undemocratic. Considering that the ruble zone led to hyperinflation and sharp output decline in all the countries concerned, and that none of them stayed democratic, we can conclude that gradual currency reform was a failure.

Third, the gradual hike in energy prices created one of the biggest sources of rent seeking the world has ever seen, and it delayed the necessary adjustment of the Russian economy. The energy lobby favored low energy prices because it could buy energy cheaply at home and charge world market prices abroad.

Fourth, the most gradual process in Russia was its democratization, and it appears the most unsuccessful. Political compromise was possible immediately after the August 1991 coup, but not later on. The problems lay not in knowledge or technicalities, but in interests that were diverging over time.

All these examples suggest that early, radical reforms were better than gradual, delayed, or partial reforms. So why did some scholars object to radical reforms as such? Only the main lines of argument in this wide-ranging discussion will be summarized here.<sup>6</sup> Some argued that the Soviet reformers should have followed the Chinese path of reform, but as discussed in chapter 1, the Soviet preconditions were completely different.

Second, many wanted to limit the shock of liberalization and stabilization, assuming that then the costs of transition would be smaller. However, these arguments have been empirically disproved by a large literature of regression analysis, which has shown that more radical reforms have caused less output decline, a faster return to economic growth, and less social suffering (De Melo, Denizer, and Gelb 1997; Berg et al. 1999; Havrylyshyn and Wolf 2001; Campos and Coricelli 2002).

A third gradualist argument was that institutions had to be built first, which requires time (Murrell 1992a, 1992b; North 1994; Yavlinsky and Braguinsky 1994; Braguinsky and Yavlinsky 2000). Empirically, however, no postcommunist country that delayed reforms built more or better institutions than those that launched more radical reforms (Havrylyshyn 2006). Critics disregarded the substantial institution building undertaken by the radical reformers, and they did not understand the revolutionary nature of events. Therefore, they recognized neither the existence nor

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6. I have pursued this discussion at length elsewhere (Åslund 2002, 2007a).

importance of using a brief window of opportunity. Nor did they see the strength of the rent-seeking interests.<sup>7</sup>

Fourth, in political science, transitologists advocated a gradual and paced transition because they noted that democratizations in Latin America that had been negotiated and agreed with the old elite tended to survive (Karl and Schmitter 1991). But the unrepentant and entrenched communist elite in Russia was not ready to compromise, as the two coup attempts made evident. Therefore, no evolutionary reform was possible in the Soviet Union. Any marketization or democratization had to be revolutionary. Otherwise the old communist establishment would prevail. Russia's obvious alternative was a restoration of the old system without communist ideology as happened in Belarus.

After the Russian financial crash, Joseph Stiglitz (1999a, 2002, 2006) became the most illustrious critic of the Yeltsin-Gaidar reforms. He attacked International Monetary Fund (IMF) policy on Russia, the Washington consensus, and privatization, while embracing all the prior gradualist arguments. Stiglitz even stated: "The Gorbachev-era *perestroika* reforms furnish a good example of incremental reforms," disregarding that they led to economic collapse (Stiglitz 1999a, 24). He thought Russia should have followed China's example, focusing on the growth rates, but he ignored the very different preconditions. He commended communist institutions: "Once dissipated, organizational capital is hard to reassemble . . ." (Stiglitz 1999a, 9). It is unclear whether he realized that he thus endorsed communist dictatorship (Mau 1999). Logically, Stiglitz praised nonreforming and tyrannical Uzbekistan: "Countries that were castigated a few short years ago for the slowness and incompleteness of their reforms, such as Uzbekistan and Slovenia, are performing rather well, whereas other countries heralded as models of reform, such as the Czech Republic, are now encountering difficulties" (Stiglitz, 1999b, 4).

The fundamental difference between gradualists and radical reformers was their view of market failure and state failure. Gradualists regarded the old communist economy and state as more viable than radical reformers did, and they downplayed the economic crisis after communism. They refused to accept that the communist state was highly corrupt and that rent seeking was rampant, focusing on market failures, such as possible monopoly effects, while radical reformers emphasized speed because they feared the transition to market economy would fail. Finally, gradualists wanted to stimulate output through demand management, while radical reformers saw a lack of supply as the prime problem. Many gradualists retained more socialist views than they wanted to reveal.

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7. A lucid example is Stiglitz (1999a, 9), who complained about radical reformers who "blame the failure of the shock therapy reforms on corruption and rent-seeking at every turn . . . without recognizing any role of the institutional blitzkrieg in destroying but not replacing the old social norms. . . ."

The arguments for radical reform are many. Changes must be credible and the economic system consistent to function, which requires that the intellectual paradigm change. Critical masses of markets and private enterprise were required for economic recovery and irreversible transformation, since the danger of reversal was considerable. Quick macroeconomic stabilization has proven most effective.

Drawing on the Russian transformation, two groups of arguments for radical reform stand out. The first is that Russia was in a revolutionary situation. The old regime had not been finished off but was suspended for a brief time. The Russian leaders had only a short window of opportunity. They should be judged by how well they used this chance.

The other argument was best presented by Joel Hellman (1998) in his seminal article "Winners Take All." His fundamental insight was that rent seeking was the main game in town. Reformers had a brief chance to act against it. Otherwise rent seeking took over in both economics and politics. State managers and new entrepreneurs had won big through rent seeking in the transition. They "used their power to block new market entry" and "undermined the formation of a viable legal system." Hellman reckoned that the winners had "developed a stake in the very distortions that impede the realization of the efficiency gains of a fully functioning market" (p. 233).

Murphy, Shleifer, and Vishny (1993) explained that this was likely to happen because rent seeking generates increasing returns. The establishment of a rent-seeking machine required fixed costs, but when it had been established it favored the rich and powerful, and the risk of punishment diminished with their dominance over the state. The obvious policy conclusion was that the politics and economics of transition had to focus on beating the interests of the prime rent seekers, which meant both fast democratization and radical market reform.

I am not aware of any full-fledged prescription for what the building of democracy should entail, but Michael McFaul (1993, 1997, 2001) has probably said it all. After elementary political and civil rights had been established, several building blocks of democracy were necessary. First, the old parliament had to be dissolved and new parliamentary elections held within a year after the democratic breakthrough. Second, to encourage the evolution of normal political parties, those founding elections should be based on parties, preferably be proportional, and have a reasonable threshold for representation of 4 or 5 percent. Third, the old constitution, with the sovereign and undivided power of the parliament, should be replaced with a constitution containing a clear division of legislative, executive, and judicial powers. Fourth, a clear division of powers between the federal, regional, and municipal governments was also desirable. Fifth, a parliamentary system would have been much preferable to a presidential system, because of its greater transparency and accountability. These are the building blocks of a democracy that Russia

lacked. All of them could have been introduced before April 1992, but none was even attempted.

Viktor Sheinis (2004, 60), a former Yabloko deputy and specialist on the Russian constitution, noted that the “surge toward democracy immediately after the events of August 1991 was the time when a democratic constitution was most likely to pass, and this moment was lost.” The quality of the constitutional drafts did not improve but deteriorated over time: “The compromising nature of the draft was a weakness, not a strength.” McFaul (1993, 89) concluded: “Russia’s poor sequence of elections has inhibited the stabilization of democratic politics. . . .”

## **Essence of Privatization: Legitimate Property Rights**

The discussion on privatization has been wide-ranging and intense. Initially, many observers were impressed by Russia’s fast mass privatization. However, both enterprise restructuring and economic growth were delayed. The loans-for-shares privatizations and Russia’s corruption made many dismayed over dubious morals, and the financial crash of 1998 all the more so (Stiglitz 1999a, 1999b; Black, Krakkman, and Tarassova 2000). Strangely, many blame all negative phenomena on privatization, which was the most consistent reform undertaken, as if privatization and not the dearth of other reforms was the problem.

The empirical evidence is vast and quite consistent. Multicountry regressions have invariably shown that privatization had a positive impact on GDP (De Melo, Denizer, and Gelb 1997; Berg et al. 1999). A multitude of enterprise surveys have been undertaken. Overwhelmingly, they show that private firms are doing better than publicly owned corporations. Start-ups and foreign-owned companies have done especially well. New outside owners are better than the original managers (EBRD 1999; Havrylyshyn and McGettigan 2000; Megginson and Netter 2001; Djankov and Murrell 2002; Brown, Earle, and Telegdy 2005).

Private ownership of enterprises has many positive effects on the economy as a whole. As early as 1999, the EBRD and the World Bank Business Environment and Enterprise Performance Surveys showed that private enterprises are rarely monopolies and extract much less subsidies than state corporations (EBRD 1999).

A concern has been that companies privatized by insiders or with vouchers were less efficient for many years (Brown, Earle, and Telegdy 2005). After 1999, however, the high growth rates in the former Soviet Union have changed the picture. Now, countries that undertook mass privatization have actually grown faster than those that carried out case-by-case privatization and mass privatization appears to be the key explanation (Bennett, Estrin, and Urga 2005). Russia has experienced a big wave of mergers and acquisitions, rendering both owners and managers fluid,

which has driven enterprise restructuring and economic growth. Therefore, it is becoming less important how an enterprise was privatized, while private ownership is vital.

Today, the greatest economic concern is whether Russia will be able to secure property rights of big enterprises. The confiscation of Yukos set a bad example. Currently, one big private enterprise after the other is being renationalized, which has many harmful economic consequences. Renationalization is reportedly often connected with kickbacks. With little transparency or accountability, state enterprises are bound to corrupt top officials, offering them easy access to great wealth. Their insecure property rights compel big Russian businessmen to invest hundreds of millions of dollars in politics, further aggravating corruption.

Virtually all sales to outsiders have been highly controversial. Ironically, the most open and transparent auction of Svyazinvest in July 1997 was the most loathed privatization. Nor did it help that the highest price was attained and paid in cash. The second most despised privatizations were the loans-for-shares deals, which generated the second largest state revenues before 1998 and revitalized the enterprises excellently. Evidently, subsequent economic success makes a privatization more disputed because it arouses the impression that the enterprise was worth more than was paid.

Initially, mass privatization and insider privatization were significantly less successful economically, but politically they have been more easily accepted. Hence, their resulting property rights are more legitimate. If that is the vital value, a positive reevaluation of these forms of privatization is called for. The conclusion is that it is far more important that privatization is politically acceptable than that it is economically optimal, because private enterprises generate so many positive effects in any case. Anybody who buys a company from the state suffers, because the politicized state is unable to make a fair transaction.<sup>8</sup> The optimal business approach is to buy enterprises on the secondary market and leave the hazards of privatization to others.

To stave off renationalization, a sector needs to be completely privatized. Remaining state enterprises are so harmful that almost any privatization is better than no privatization. In 2003, only 10 percent of oil production occurred in state companies, but by summer 2007 that share had risen to 55 percent. If only the small state corporation Rosneft had been privatized, like had been planned since 1997, Russia's oil sector might still be private, as the entirely private steel and coal sectors. One remaining state firm in an industry is a cancer that can cause metastasis. If a big state

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8. Alexis de Tocqueville (1856/1955, 101) noticed a similar phenomenon before the French revolution: "we constantly read of royal property being sold, then declared 'unsalable' and taken back; of broken pledges; of established rights being brushed aside. In every financial crisis the creditor of the State was victimized and the government broke faith with the governed."

company is allowed to dominate an industry, the danger is great that it will claim monopoly of the whole sector, as Gazprom has done.

## Policymaking in the Midst of a Revolution

These observations lead us to more general conclusions about how policy should be made in the midst of a revolution. On the one hand, the state apparatus is suspended. On the other, many social forces are also paralyzed. This situation allows top policymakers to make more radical decisions than under normal conditions. At the same time, the capacity of government is sharply reduced, so it needs to focus on principles and cannot manage details. If policymakers do not use this window of opportunity, rent seekers will decide instead, and they will do so to their advantage.

Policymaking during a revolution can be divided into six subsequent steps: ideas, operative policy advice, political leadership, policymakers, parliamentary support, and policy implementation. We shall examine what was done to market reform and democracy at each stage.

First come *ideas*, as Keynes so rightly pointed out. A revolution means rethinking, the introduction of a new intellectual paradigm. The ideas of radical market economic reform came from the Balcerowicz (1992) program in Poland, which were a concretization and radicalization of the Washington consensus (Williamson 1990). Radical market reforms have been implemented in many countries, and they have stood the test of time. The dominant economic reform idea was economic freedom.

The Russian reformers were shy about being ideological because the communists had given ideology a bad name. Hilary Appel (2004) has rightly observed that Václav Klaus was politically more successful with privatization in the Czech Republic than Chubais because he sold it as an ideological mission, while Chubais tried to sell it on the basis of direct material benefits of various stakeholders.

Second, an idea needs to be translated into *operative policy advice* to be relevant. Yeltsin's (1990) big reform speech on October 28, 1991, could have been more detailed, but it clarified the design of the economic reform: Prices and trade would be deregulated, and the budget brought close to balance. Enterprises should be privatized. The Gaidar team should have worked out a more specific program, but the policy was reasonably clear.

Third, *political leadership and a clear policy declaration* from the top political leader are needed. Yeltsin's big reform speech was such a declaration about economic reform.

Fourth, *operative policymakers* or reform ministers are needed. Yeltsin appointed a reform government of young professional economists on November 6–8, 1991. Usually, major reforms are undertaken by young professional economists coming from outside, bringing in foreign knowledge (Williamson 1994).

Fifth, *parliamentary support* is vital. A market economic reform requires the adoption of hundreds of new laws, and only an orderly legislative process can generate high-quality legislation. Yeltsin put his reform speech to a vote and obtained nearly unanimous support. Alas, his extensive rights to rule by decree for one year alienated and circumvented the parliament and thus harmed economic reform. This and the absence of democratic reform were the greatest shortcomings in Russia's economic reform process.

Sixth, *policy must be implemented while ordinary politics is in suspension*, what Leszek Balcerowicz (1994) called the time of "extraordinary politics." In Russia, it lasted from late August 1991 until the end of March 1992. The two first months were understandably devoted to preparations of strategy, leaving an actual window of opportunity of only five months, when most of the important economic reforms were adopted. Considering that time was so short and policymaking capacity limited, decisions had to be simple. Another reason for simplicity was that the government apparatus was at best passive but usually actively sabotaged policies.

International organizations could support reforms in several ways. They could offer advice, suggest benchmarks or conditions, and they could provide financing. The IMF, the World Bank, and the US Agency for International Development (USAID) did so for marketization, financial stabilization, and privatization. The problem, however, was that their financing did not start during the first year of reform, when it was most needed. Timeliness is crucial for the efficacy of international assistance.

As for democracy, no clear idea was presented on how to build democracy in Russia. If you do not know what to do, you achieve nothing. Without any detailed idea of what democracy entailed, nobody could say how to build it.<sup>9</sup> Consequently, Yeltsin never made a big reform speech on democracy because neither ideas nor priorities were evident. As no political reform was under way, no political reformers were brought into the government. Nor could parliamentary support be mobilized, and there was nothing to implement.

No international organization is responsible for democracy building. Two international organizations, the Council of Europe and the Organization for Security and Cooperation in Europe (OSCE), organize election monitoring, which is an important but limited element of democracy building. Not surprisingly, political scientists assess several post-Soviet countries as "electoral democracies," meaning that they hold formally correct elections, but not "liberal" or full-fledged democracies (McFaul 2001; Zakaria 2003). The only postcommunist countries that have become full-

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9. Michael McFaul (1993, 89) emphasized the need for early parliamentary elections after the democratic breakthrough to develop political parties, but that was just one dissenting voice. In his memoirs, Gaidar (1999, 265) singled out McFaul and me as proponents of early elections in 1991 (which he considered impossible).

fledged democracies are those that have been admitted to the European Union, because they have to adopt all EU laws, which include democracy. The failure of democracy in Russia and the whole of the former Soviet Union is the intellectual failure of the international community to conceptualize democracy building.

In sum, Yeltsin and Gaidar got the essentials right about economic reform, but the lack of political reform harmed it through the malfunctioning of the legislature. It took the catharsis of the financial crash of 1998 to complete Russia's market economic transformation. The fundamental shortfall of political reform was the dearth of any clear idea of how to build a democracy. Political scientists were more preoccupied with the politics of economic reform than with democracy building. Consequently, little was done. It was not economic "shock therapy" but the absence of decisive political reform that led to an exhausting political crisis, which culminated in the bloodshed of October 1993, which badly stained Russia's nascent democracy.

The key issue during a revolution is what trajectory is chosen. Russia's choice was between radical market reform and democratization, on one hand, and partial market reform leading to rent seeking and authoritarianism, on the other. If reformers did not fight for the first option, the alternative would win by default. The short explanation of why market reform succeeded in Russia, while democracy failed, is that the initial big bang of radical economic reform was sufficient, while democratic reforms were never designed.

These conclusions suggest that the IMF and the World Bank largely acted correctly. The World Bank formulated an excellent program of radical economic reform (World Bank 1991, Fischer and Gelb 1991). It holds up very well today, and the World Bank (1996a) rightly showed that it had worked. Ironically, the World Bank has become wobbly because of the criticism by Joseph Stiglitz (2002) and Dani Rodrik (2006), ending up in general confusion and hardly daring to advise anything (World Bank 2005). Such a posture renders the World Bank of little use. It needs to go back to its sound roots of the early 1990s, restoring a basic set of coherent policy advice based on coherent market economic ideas. It neither can nor should guard itself against every exception, as Rodrik argues, because then it cannot provide relevant advice.

For democracy building, the very ground stones need to be laid. Political scientists must dare to become normative and prescribe a set of relevant policy advice for how a democracy should be built. They need to lose their academic virginity. Such policy advice, with the components suggested above, would roughly correspond to the Washington Consensus or the World Bank program for radical economic reform. In addition, an international organization for the building of democracy is called for. Naturally, such an organization must assemble only democracies, for example, the Community of Democracies. Otherwise its purpose would be

diverted. The world must not stand empty-handed the next time a democratic revolution erupts.

## **Foreign Aid: Limited but Important**

In hindsight, it is difficult to comprehend why the West did so little in Russia in 1991–92, and it was equally mysterious at the time. During that winter, the West had an extraordinary opportunity to make Russia an eternal friend, but Western governments were thinking seriously only about legal guarantees for their old debts to the Soviet Union. US Secretary of State James Baker thought of the danger of nuclear proliferation.

The West could provide relevant short-term support to Russia in its time of hardship in three ways: through advice, international standards, and financing. Although it was slow in coming and amazingly small, Western aid was important. Yeltsin spent a lot of his time on relations with the West, especially the United States and the G-7. The Western leaders were all friendly, but Russia got little out of these many meetings.

In the early 1990s, a Western newspaper reader could easily get the impression that Russia's transition was run by the IMF, because it had taken a firm lead on Russia in the international community, as the G-7 asked it to do in 1990. Both the Bush and Clinton administrations respected the IMF, and the immediate concern was macroeconomic stabilization. In addition, the IMF controlled large funds that could be lent to Russia without any approval by Western parliaments. The IMF was also more aggressive and effective under the leadership of Michel Camdessus and Stanley Fischer than any other international organization. It acted faster and had competent staff.

The most important task of international assistance was to provide Russia with a normal market economic paradigm. This was an ideological task, and ideas came primarily from independent economic advisors financed by nongovernmental organizations. The leading nongovernmental organization was George Soros' Open Society Institute, which financed civil society activities, research, qualified education, and textbook writing and translation (Soros 1991). A market economic paradigm was transferred to Russia independently and at minimal expense. The IMF, the World Bank, and the EBRD provided important backup, but they were slower in coming.

The second assignment was macroeconomic stabilization. One element was to introduce decent financial and monetary policies. A second element was to regulate overwhelming Soviet debts, and a third to finance Russia's international reserves. This was the task of the IMF. Unfortunately, the first year was lost because Western initiative was lacking. The official excuse was that Russia was not yet a member of the IMF and the World Bank, but nor was anything done about debt relief. The IMF

provided no financing in the five-month window of opportunity November 1991–March 1992, when everything seemed possible. Because of the complete absence of currency reserves, Russia’s average wage fell to \$6 a month in December 1991, which was a horrendous humiliation to the Russian people. There was never any economic advantage of letting it fall below \$100 a month. The West could have helped, but it did nothing. This failure to act should be blamed on President George Bush rather than the IMF that lacked mandate.

The other major mistake by the IMF was its policy on the ruble zone. It was partly intellectual, partly political. The Russian reformers and their foreign advisors wanted to dissolve it as soon as possible drawing on the precedent of the dissolution of the Habsburg Empire. The IMF preferred to stay out of this battle, which it reckoned was political (Odling-Smee and Pastor 2002). Many IMF shareholders opposed breaking up the ruble zone, notably the European Union, which was building its own monetary union at the time. The IMF could have salvaged Russia and the other Commonwealth of Independent States (CIS) countries from hyperinflation, but it failed to do so.

When the IMF finally came to play a role, the reformers had already been marginalized, and a big early stabilization program was no longer possible. The IMF advanced through incremental steps. From 1993, it concluded more or less annually a stabilization agreement with Russia. Two of these were successful. In 1993, Minister of Finance Boris Fedorov concluded a soft Systemic Transformation Facility agreement with the IMF with a one-year credit of \$3 billion. It helped Fedorov carry out important structural improvements, being conditioned on the elimination of import subsidies and subsidized credits. The IMF’s finest achievement was its first full-fledged standby agreement with Russia in April 1995, with \$6.8 billion in financing in one year. It led to substantial fiscal adjustment through cuts of enterprise subsidies and to a temporary stabilization (Odling-Smee 2004).

Two other IMF programs, however, were too political to be successful. In 1994, Chernomyrdin was fully in charge, and thanks to his diplomatic skills, the IMF concluded an agreement in April 1994. But the program never looked serious. The IMF staff opposed it, but they were overruled by the US Treasury. Because of political pressure from the G-7, Camdessus was “more willing to settle . . . for an economic program that was less strict than he would have liked, to preempt any undue pressure from the G-7. Perhaps more importantly, the U.S. statements produced a hardening of the Russian position” (Odling-Smee 2004, 13). In the spring of 1996, the IMF concluded a three-year Extended Fund Facility of \$10.2 billion with Russia, which was quite a disaster economically. The US government and G-7’s political interventions to help Yeltsin get reelected were evident and heavy-handed, convincing everybody that in Russia the IMF was only concerned about politics. After the summer 1996 elections, by contrast,

Russia's government ignored the IMF because of the large foreign currency inflows.

In 1998, the IMF came back with force. IMF staff knew what to do, when Russia's financial crisis turned rampant. With substantial credit commitments of \$23 billion, the IMF and the World Bank showed that they cared about Russia's fate. But the Russian Duma blocked the necessary tax legislation to make Russia's stabilization viable. Russia's stabilization could no longer be salvaged, and the IMF, the World Bank, and the US Treasury let it sink. Through this act, the IMF restored its credibility, but this seemed a callous act that might have alienated Russians from the West and undermined their belief in democracy.

The frightful crash of 1998 taught Russians all they needed to know about macroeconomics. The IMF could have withdrawn and declared victory. Soon, Russia returned all its IMF credits of \$20 billion, and the IMF could present Russia as a success story (Owen and Robinson 2003). After seven years, Russia's financial stabilization was completed, which was no mean feat, even if it ideally could have been done in two years.

The third big task involving foreign assistance was to build a market economy and privatize the economy. Here, the World Bank took the lead. Its greatest achievement was to facilitate the mass privatization, cooperating closely with the US Agency for International Development (USAID). The World Bank was also deeply involved in all other structural reform. A major success was the restructuring of the coal industry through privatization and deregulation. However, the World Bank could achieve little in social reforms, because of the dearth of serious Russian counterparts. The Bank contributed intelligently to the Russian economic discussion, and eventually much of its sound analysis was implemented.

The only big task that remains for the West is to welcome Russia into the World Trade Organization (WTO). Russia applied for membership in 1993, but the Russian leaders did not take negotiations seriously until 2000. Putin instigated great progress during his first term, but then he appears to have lost interest. Because of its dominant commodity exports and the world boom, Russia has had few problems selling its products without being a member of the WTO (Åslund 2007b). Yet Russia's growth should increase by 0.5 to 1.0 percent a year in the medium term when the country joins the WTO (Jensen, Rutherford, and Tarr 2004).

The West could have done much more for Russia in 1991–92. The amounts required were minor, approximately \$25 billion in loans, but timeliness was vital, and the West held back because of poor analysis. Total Western grant assistance to Russia has been tiny: –\$2.6 billion from the USAID in 1990–2000 and \$1.4 billion in EU grant assistance. Total IMF loans amounted to \$20 billion and World Bank commitments to \$11.7 billion by 1999 (Åslund 2002, 420–29). This does not include military security spending, which benefited Western security, and food “aid,” that is, cred-

its supporting Western agricultural lobbies. In fact, Russia's servicing of the old Soviet debt exceeded all government and intergovernmental grants and credits by far, so Russia was actually financing the West in the midst of its hardship (IMF 2000, 62).

Yet, the West got what it cared about. The dominant G-7 interest was to secure claims on the Soviet Union, and they were paid back in full. The US cared about nuclear nonproliferation, which was accomplished. Multiple Western forces promoted market economy in Russia, which was successful. Few in the West bothered about democracy or Russia's future direction, so we should not be surprised if those achievements were minimal.

## Russia's Future: Contradiction Between Economic Miracle and Reactionary Politics

Russia's future lies in the contradiction between fast economic modernization and a reactionary authoritarian political system.

In 1993, Daniel Yergin and Thane Gustafson (1993) published the book *Russia 2010* presenting four different scenarios for Russia in 2010. Their most positive scenario, *Chudo* (miracle), corresponds closely to Russia's current economic situation. The government has secured macroeconomic stabilization, and the economic growth reaches 9 percent, driven by private business. This economic miracle is modeled on the German and Japanese postwar miracles (pp. 162–65). Two early books on Russia's economic transformation realizing its positive impact were Granville (1995a) and Layard and Parker (1996).

Politically, however, Yergin and Gustafson's "Two-Headed Eagle" scenario fits better. The government is noncommunist but conservative and statist, with the exports of natural resources being brought back under the control of state monopolies. It is based on a coalition of managers of large industries, the central bureaucracies in Moscow, and the *siloviki*. Its key feature is "the reconstitution of a stronger central government" (pp. 134–36).

Russia's economic progress is impressive. Real growth has been nearly 7 percent annually since 1999. In current dollars, however, Russia's GDP has quintupled from \$196 billion in 1999 to \$979 billion in 2006, becoming the 10th biggest economy in the world (IMF 2007). This corresponds to an annual increase of 25 percent and Russia's leaders feel it. Russia's GDP per capita at current exchange rates is still four times higher than China's.

In a much-noticed paper, Goldman Sachs projected that even with an average annual growth of only 3.9 percent, Russia's GDP would overtake Germany's in 2028, and Russia would become the fifth biggest economy in the world after the United States, China, Japan, and India (Wilson and Purushothaman 2003).

The Goldman Sachs study preceded the current oil boom, which has boosted the Russian economy further. Peter Westin considered the effects

of higher oil prices. Assuming stable oil prices at \$50 per barrel, Russia's GDP would grow by an annual average of 5.9 percent until 2015 (Westin 2005). Then, Russia would become the fifth biggest economy in the world before 2020.

Three fundamental conditions make it possible for Russia to generate this steady and high economic growth. First, Russia has established a normal market economy based on predominant private enterprise. It has adopted a liberal tax system with moderate and relatively flat tax rates. The overall lesson from transition countries is that public expenditures must not exceed 35 percent of GDP, as is the case in Russia (Gray, Lane, and Varoudakis 2007). In general, a higher tax level is neither justified nor beneficial for economic growth (Tanzi and Schuknecht 2000).

Second, the financial crash of 1998 was so severe that Russia is likely to maintain strict macroeconomic balance for a generation. The current macroeconomic policy is if anything overly cautious with budget surpluses of 7.5 percent of GDP in 2005 and 2006 and current international reserves of 40 percent of GDP, though neither is likely to hold for long.

The third factor that underlies Russia's dynamism is the single-minded focus on economic growth of not only the president but also the intellectual establishment. Russian economists of all colors are preoccupied with economic growth (e.g., Gaidar 2005). The peer pressure from neighboring countries is strong as well. The whole Eurasian region from China via India to the Baltics has been growing steadily by 7 to 11 percent a year since 2000. Russia is actually comparatively less dynamic.

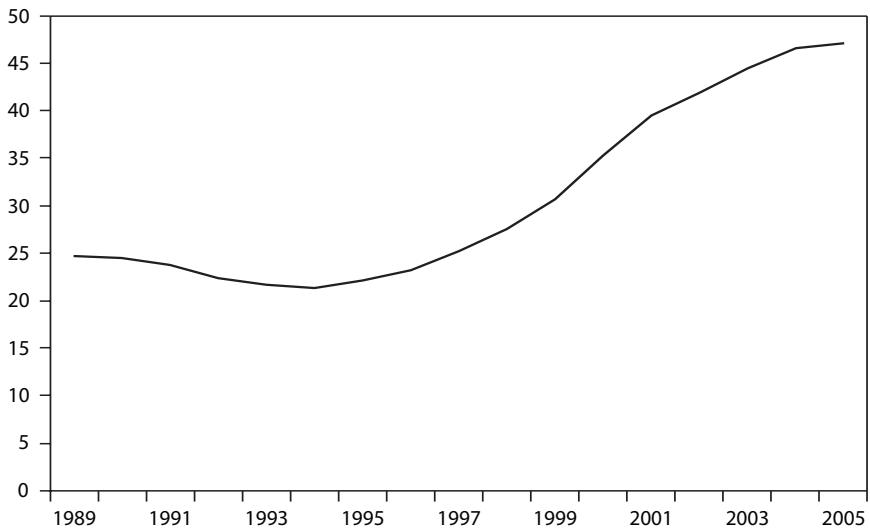
Of these three factors, Putin can claim the focus on growth and the conclusion of the economic reforms, but the systemic transformation was largely done in the 1990s, and the respect for macroeconomic stability resulted from the crash of 1998. Growth accounting shows that after 2000, half of Russia's growth arises from capital and half from rising total factor productivity, while labor has given a minor positive input (Iradian 2007).

In addition, several profound structural changes are under way and they should contribute to growth. One of the least noticed factors is the relentless rise in the number of registered enterprises of 7 percent a year. With 5 million registered enterprises (figure 6.9) and at least 4 million registered individual entrepreneurs, Russia has a total of 9 million firms, which means one enterprise per 16 people or approximately as many as in Western European countries.

Another indication of Russia's ambitions is that Russia is swiftly becoming a middle class society with a middle class of at least 20 to 25 percent of the population (Maleva 2003). Ever more young Russians opt for higher education. According to UNICEF statistics, the share of Russian college-age youth that pursue higher education nearly doubled from 25 percent in 1989 to 47 percent in 2005 (figure 8.3). With a broader definition of higher education, UNESCO (2007) arrived at 71 percent for 2005, more than the average for the European Union.

**Figure 8.3 Share of college-age youth going to higher education, 1989–2005**

gross ratio, percent of population aged 19–24



Source: TransMONEE 2007 Database, [www.unicef-irc.org/databases/transmonee](http://www.unicef-irc.org/databases/transmonee) (accessed on May 28, 2007).

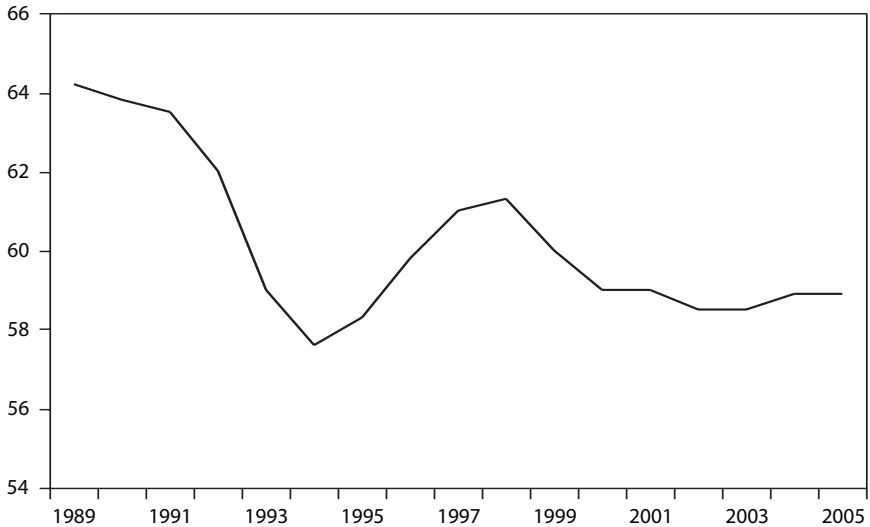
A common feature of the postcommunist economies is a large pent-up need for investment financed with the remonetization and releveraging of the economy. In 2005, Russia's M2 as a share of GDP was as little as 28 percent of GDP (EBRD 2006), while 70 to 80 percent of GDP would be a normal level for a European market economy. As long as private property prevails, Russia has plenty of collateral for more than twice as large a credit volume without any apparent financial risks. Considering that its investment ratio is still moderate, Russia has room for higher growth.

One more indicator that passes unnoticed is that since the financial crash, the profits share of GDP has been quite extreme, amounting to no less than 37 percent of GDP in 2005, if we believe the official statistics (Goskomstat 2006). This explains why Russia can have both 53 billionaires and substantial investment (Kroll and Fass 2007).

An additional factor stimulating Russia's growth is the country's fast integration in the world economy. Russia's total exports have surged from \$42 billion in 1992 to \$305 billion in 2007. Much of the increase has come from rising oil prices, but Russia's economy is diversifying, and the share of oil and gas in Russia's exports has fallen to 60 percent from 90 percent of Soviet exports to the West in the late 1980s.

**Figure 8.4 Life expectancy for men (at birth), 1989–2005**

total number of years



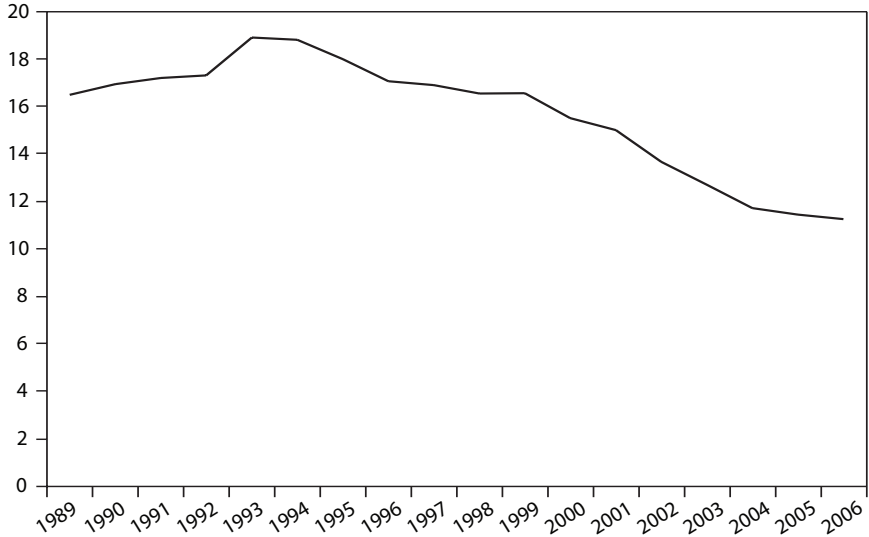
Source: World Bank, *World Development Indicators* database, <http://devdata.worldbank.org/dataonline> (accessed on May 27, 2007).

Russia's labor market is tight, but the demographic situation is quite flexible. For years, demographers have claimed that the Russian population will decline by one-third in 50 years, but the Russian population has barely shrunk by 3 percent in the last 17 years (World Bank 2007). The explanation is that Russia has benefited greatly from the immigration of millions of people from former Soviet republics, many of them ethnically Russian and all Russian-speaking.

A major concern, however, is that male life expectancy fell by 7 years from 64.2 in 1989 to 57.6 in 1994 (figure 8.4). A quick recovery until 1998 suggested that this was a temporary phenomenon, but a subsequent decline showed that it was not. For years, Russia's life expectancy for men has lingered around 59 years, which is extremely low. The main killer is cardiovascular disease, followed by manifold violent deaths. The all-dominant explanation is excessive consumption of alcohol. Russian men have always been known to be heavy drinkers. With lower relative prices of alcohol combined with the uncertainties of transition, they started drinking even more heavily, drinking themselves to death on a massive scale. Russian women, by contrast, live 13 to 14 years longer than their men, having a normal life expectancy for a relatively developed country (Shapiro 1995; Vishnevsky and Shkolnikov 1997; Brainerd 1998; Shkolnikov, Andreev,

**Figure 8.5 Infant mortality, 1989–2006**

per thousand births



Source: US Census Bureau, international database, [www.census.gov/ipc/www/idb](http://www.census.gov/ipc/www/idb) (accessed on May 30, 2007).

and Maleva 2000). Strangely, the Russian government pays little attention to alcoholism and does hardly anything to improve the situation, even if Putin shows a good example by drinking minimally.

Russia's health care sector might not be great, but it is not the cause of the low male life expectancy. Infant mortality reflects the performance of the health care system. After a slight rise at the beginning of transition (which is probably explained by a change in definitions), infant mortality fell steadily by 40 percent from 1993 to 2006 and the decline continues (figure 8.5). After communism, health care is receiving much larger resources. Unlike in Soviet times, all kinds of medicines and equipment are now available, although the efficiency of public health care remains deplorable.

The worst economic threat is if renationalization were to make the state sector dominant again. Then the Russian state would kill the private geese that have been laying all the golden eggs it is living off. Yet, renationalization is likely to be contained for many reasons: the focus on economic growth, the absence of socialist ideology, and the faster growth of private enterprises and sectors dominated by them. Neither the dominant private sector nor the market economy appear to be in danger. However, the higher the oil price is, the worse Russian economic policy is likely to be.

A specific concern is that the output of key state enterprises, such as Gazprom and the transportation corporations, will fall short of demand and create major bottlenecks because of shortages of gas, power, or transportation. Again, this would harm economic growth, and the government would probably react pragmatically by letting in private enterprise. Still, the needed long-term investment could be much delayed.

The obsolete state is bound to preserve Russia's numerous state failures, as reflected in the patently flawed bureaucracy, law enforcement, public health care, public education, and public infrastructure. The common denominator of all these problematic sectors is public ownership. These state failures are expressed in endemic corruption, high murder rates, and high traffic deaths. These drawbacks have been lasting features of the new Russia, and they are not likely to go away until the country becomes democratic. An obvious corollary is that the Russian state should be small because it is likely to stay inefficient, ineffective, and corrupt for many years.

The worst political specter for Russia is fascism. The parallels between post-Soviet Russia and Weimar Germany are many and much discussed—an empire lost, hyperinflation, sharp output decline, a strong authoritarian tradition, spiritual vacuum, and fast, confusing transformation (Gaidar 2006). Many of the Kremlin's endeavors point in this direction, notably the formation of *Nashi* (Ours), a youth group reminiscent of both Hitler *Jugend* and Hitler's SA, his storm troopers (Buckley 2007). Russian state TV spews nationalist and anti-Western propaganda. The Kremlin has sponsored nationalist parties and movements, such as the LDPR and Motherland. Putin himself makes anti-Western speeches and calls for ethnic discrimination in favor of Russians (for example, Putin 2004c, 2006b, 2007a). Even so, the popular response to hard-core nationalism pushed by the Kremlin remains quite limited, and the fascist scenario looks unlikely.

Russia is simply too rich, too economically pluralist, too educated, and too open to be so authoritarian (Lipset 1959; Acemoglu and Robinson 2006, 358–60). This contradiction between an increasingly obsolete political system and a swiftly modernizing economy and society is likely to be untenable even in the medium term. No modern society can function without unbiased information or checks and balances. Putin cannot make decisions of high quality about everything after having abolished all feedback and concentrated so much decision making to himself. His regime is too rigid and centralized to handle crises, which always occur in Russia. Therefore, it can hardly be very stable.

Against this latter-day police state stands a rising middle class. Yet, Russia's current authoritarianism is quite sophisticated. While the middle class is being pampered with a high standard of living, political dissent is severely punished. Under such conditions, few are tempted to join the opposition. The costs are too high, and the probability of success too small.

The weakness of the political system lies elsewhere. It is likely to break from the top or the bottom. At the top, Putin has divided the elite in fierce competition to make sure that all need his arbitration. Each group of his KGB men sits on one or several state companies. Since these corporations pertain to different industries, they often have opposing interests and cannot collude. Considering that their struggle involves billions of dollars in contracts that cannot be legally secured, they are likely to protect their contracts by all means.

An important political weakness of Putin's system is that it does not have much to offer to the working class. Despite hikes, their wages remain relatively low; they die early from alcoholism; and they have no voice. Although Russia has experienced very few strikes, the current situation could easily breed strikes among elite workers, such as oil workers, while the system is too centralized to handle crises. Putin is continuously tightening his grip on information about all mishaps, but eventually some disaster may become too embarrassing.

Corruption has become more pervasive than ever, and it is difficult to escape the impression that it is a driving force in Putin's Russia. In East-Central Europe, corruption has been the main popular argument against every incumbent government (Krastev 2000), and it is worse in Russia. Even if corruption has been rationalized, it undermines the functioning of the state. Law enforcement, in particular, is unreliable, as evidenced by the successful entry of Chechen terrorists in the Moscow Nord-Ost and the Beslan hostage dramas. Prominent Russians often argue that Russians accept corruption, but it is never popular, even if elites hope so. In a survey in 2000, 70 percent of Russians said that taking a bribe is "never justifiable" (Fish 2005, 131–32).

Putin is supposed to end his presidency and a new president be elected in March 2008, but it is difficult to see how that could happen. Putin is healthy and young, immensely ambitious, and has no evident future post. He has systematically deinstitutionalized the political system, rendering it entirely dependent on himself. Several of his top aides have publicly called for a third term for Putin. They argue that the state would collapse without him. They might be right. If he had intended to retire, he would have been better advised to strengthen the rule of law, so that he could feel as secure as Gorbachev and Yeltsin did out of power.

Putin has vaguely implied that either of the first deputy prime ministers, Dmitri Medvedev or Sergei Ivanov, may replace him, but he has not anointed any candidate, and neither of these heirs apparent has declared his candidacy. Both are considered too weak to be president, and they have advanced only thanks to Putin. Admittedly, the constitution does not allow a president to stay for three terms, but considering that most other laws are disregarded, why take this article so seriously? Yelena Tregubova (2003, 55) reported a conversation with Putin in 1999, when he was FSB chairman. Then, the question was whether the Constitutional Court would

rule in favor of a (clearly unconstitutional) third term for Yeltsin. Putin answered: "I tell you that the Constitutional Court will make such a decision as is necessary."

Putin could have changed the constitution already, but then he would have revealed his cards, and he loves to surprise. The current uncertainty allows him to keep everybody, including his closest associates, in suspense. He has said many times, both publicly and privately, that he intends to step down because the constitution says so. But given his record of doing the opposite of what he says and ignoring the law, his repeated statements are a strong indication that he will stay.

This book has focused on policymaking, emphasizing how much could have been done to build democracy, while few of these possibilities were used. In a broader historical perspective, however, it is not surprising that Russia's attempt at democratization failed. That is often the case, especially if the initial conditions are as adverse as in Russia (Linz 1978). Russians blame democracy for all their hardship in transition, not recognizing that communism had put them in jeopardy. Nor do they acknowledge the construction of a new economic system that was carried out in the 1990s. Many circumstances contributed to the backlash against democracy: It was seen as linked to corruption, lawlessness, financial instability, and insecurity. The absence of a strategy of democratization made this failure a near certainty, and democracy building will remain miserable if the world does not learn from the sins of omission in Russia.

In world history, economic and political pluralism have largely developed in parallel, with market developments usually preceding democracy. A market economy is often seen as a necessary but not sufficient condition for democracy, whereas no centrally governed economy without private ownership has been a democracy. Usually countries evolve toward political pluralism when their economies become wealthier, more open, and their populations more educated. A natural development would be that Russia in due time will throw off its authoritarian yoke and mature as a democracy, even if it needs to overcome a heavy authoritarian inheritance.

