Introduction

Russia has just completed its Capitalist Revolution, which brought down the system created by the Great Russian Socialist Revolution of 1917. The collapse of the Soviet Union, the end of communist dictatorship, and the termination of the Soviet command economy concluded the 20th century. This book takes stock of these great events and explains Russia's Capitalist Revolution.

Today, the result is evident: Russia has adopted a market economy, but it has reverted to authoritarianism. The main question of this book is: Why did market reform succeed while the building of democracy failed?

Revolutions develop along a distinct trajectory and have many similarities, even if each has its peculiarities. In a revolution, the old institutions temporarily cease to function. For a short time, this hiatus offers political leaders much greater opportunities than in ordinary times. The drawback is that the tools of government are rudimentary.

To understand the dynamics of Russia's new revolution, we need to look at the whole period of the revolution and examine both economic and political developments. Therefore this book gives equal emphasis to Russia's economic and political transformation. Foreign policy is discussed only as far as it affected Russia's internal transformation.

Russia's revolutionary surge started on March 11, 1985, when Mikhail Gorbachev was elected general secretary of the Communist Party of the Soviet Union (CPSU). Appalled by the petrification of the Soviet Union, he instantly started a broad and energetic attempt to reform communism, but as Leszek Kołakowski once told us students at a seminar at the University of Oxford: "Communism with a human face is like a baked snowball."

It is more difficult to say when the revolution was over. Currently, Russia is undoubtedly experiencing postrevolutionary stabilization. The year 2007 appears a suitable end date, because President Vladimir Putin's second term is about to finish, and he has successfully built an authoritarian system.

When institutions are suspended, political leaders become all the more important. During its two decades of transformation, Russia has had only three political leaders, Presidents Mikhail Gorbachev, Boris Yeltsin, and Vladimir Putin. Each of their insights and beliefs has had great impact on Russia's course.

This book is academic but nontechnical, designed to be accessible to a wide range of readers. It focuses on policymaking—how and why key policies were made. At the time of its writing, this is the only book covering the whole period of the Russian revolution that discusses both politics and economics. I hope that it will bring about a better understanding not only of what happened in Russia's Capitalist Revolution but also of what the actual alternatives were.

Definitions of Democracy and Market Economy

To avoid confusion, the terms democracy and market economy need to be defined. Juan Linz (1978, 5) defines democracy with a suitable degree of detail:

> Legal freedom to formulate and advocate political alternatives with the concomitant rights to free association, free speech, and other basic freedoms of person; free and nonviolent competition among leaders with periodic validation of their claim to rule; inclusion of all effective political offices in the democratic process; and provision for the participation of all members of the political community, whatever their political preferences.

The definition of a market economy has attracted less scholarly interest, because most people take it for granted. Legally, the United States and the European Union define market economies as opposed to state-trading countries in their antidumping legislation.

The US Customs Code defines a "nonmarket economy country" as "any foreign country that the administering authority determines does not operate on market principle of cost or pricing structures so that sales of merchandise in such a country do not reflect the fair value of the merchandise."[1] In making that assessment, the US Department of Commerce considers six criteria: (1) currency convertibility; (2) free bargaining for wages; (3) "the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country"; (4) "the extent of government ownership"; (5) "the extent of government control over the allocation of resources and over the price and output decisions of

1. United States Code [19 U.S.C. 1677(18)], available at the US Government Printing Office website, www.access.gpo.gov (accessed August 9, 2007).

enterprises"; and (6) other appropriate factors. Since 2004, the United States has assessed that Russia fulfills these criteria.

For our purposes, however, this definition is too slanted toward trade considerations. A market economy is best understood as the opposite of a socialist economy, as János Kornai (1992, 360–79) outlined it. First, the economic actors must be independent from the state and act freely without state commands. Second, private ownership of enterprises should dominate, and property rights need to be reasonably safe. Third, prices and trade should be predominantly free, and fourth, state subsidies must be limited. A fifth criterion could be that transactions are largely monetized. Price stability, however, is not a condition. None of these criteria is absolute, because all states distort their economies somewhat.

Theses of This Book

To offer the reader an overview of the conclusions of this book, I present a brief summary of the main arguments here.

Gorbachev's Gradual Reforms Built a Rent-Seeking Machine

Massive rent seeking characterized the collapse of the Soviet system and the early postcommunist period. Unwittingly, Gorbachev built this rent-seeking machine with his gradual reforms because the state enterprise managers, who dominated late Soviet politics, accepted only such reforms. The best way to become truly wealthy in 1990 was to purchase oil from a state enterprise at the official price of $1 a ton and sell it abroad for $100 a ton and finance the transaction with cheap state credits.

Limited decentralization of foreign trade rights started in 1986. The May 1988 Law on Cooperatives allowed state enterprise managers to set up private trading companies as well as unregulated private banks. The Law on State Enterprises, which came into force in January 1988, made the state enterprise managers the true masters of state enterprises. Oil prices stayed regulated far below the market level until 1993. State interest rates were minimal until 1993, and credit emission was ample, guaranteeing high inflation.

The reformers were aware of this boondoggle, but they did not have the necessary power to break it early on. They failed to gain control over the Central Bank of Russia in November 1991. Nor could they persuade Yeltsin to liberalize energy prices in January 1992.

Until August 1991, the state enterprise managers appeared progressive because they favored market reform and political liberalization. After August 1991, however, they were the main opponents of radical market reform because they wanted the transition period to be long and distorted to generate maximum rents, and they objected to further political reforms, which would have checked their power.

Multiple Causes Overdetermined the Soviet Collapse

By 1991, the collapse of the Soviet Union, its political system, and its economic system was certain for many reasons. The Soviet economic system was moribund, and perestroika (literally: restructuring) moved the USSR from stagnation to fatal crisis. The patently irresponsible fiscal policy from 1986 onward made hyperinflation virtually inevitable. This unfortunate policy was not caused by political pressures but by the leaders' ignorance, induced by ideological blinkers. The gradual reforms drove a wedge between control rights and cash rights and bred a machine of rent seeking. The Soviet finances collapsed in 1991 because the constituent republics stopped delivering revenues to the union treasury, and 16 central banks competed in issuing ruble credits, which sent inflation skyrocketing. All these factors rendered the financial and monetary disasters terminal in late 1990. Each of these economic problems was sufficient to terminate the Soviet Union, and together they guaranteed its demise.

National tensions sufficed to break the Soviet Union up. They were bound to erupt when repression eased because the Soviet Union lacked legitimacy in the eyes of several of its constituent nationalities. The countries and territories that had been incorporated into the Soviet Union during World War II through the Molotov-Ribbentrop Pact—the three Baltic countries (Estonia, Latvia, and Lithuania), Moldova, and Western Ukraine—had never accepted Soviet occupation. They aspired to nothing less than national independence. Georgia and Armenia had similar aspirations. Gorbachev did not comprehend nationalism, and he allowed only limited use of force, which was not enough to hold the Soviet Union together.

The final blow was that Russia democratized more than the Soviet Union through its parliamentary elections in March 1990 and presidential election in June 1991, which rendered Russia more legitimate than the Soviet Union. When Ukraine voted for independence on December 1, 1991, the Soviet Union could not be saved. The multiple Soviet collapse was a revolution that could not be stopped in its midst.

Why Did the Soviet Union not Pursue Chinese Reforms?

The natural starting point for comparison is China in 1978 and the Soviet Union in 1985, when Deng Xiaoping and Gorbachev, respectively, initiated their reforms. Virtually all preconditions were very different. China was in a political and economic shock after the Cultural Revolution, while the Soviet Union was absolutely stable after two decades of Brezhnevism.

The Chinese bureaucracy accepted change, but the Soviet party apparatus resisted it tooth and nail. Gorbachev was always forced to compromises that seriously distorted his reforms, but Deng had evidently more power.

The Chinese peasants started working hard at the first signs of reforms, while the Soviet workers knew better than to believe that reforms would last, because they had seen too many reversals.

Both Deng and Gorbachev experimented pragmatically, but in the Soviet Union the interests of state enterprise managers were dominant. They bred a rent-seeking machine, which caused the breakdown of the Soviet Union and its economic system.

After having experimented for two to three years without any economic success whatsoever, Gorbachev realized that no economic reform was possible if he did not check the party elite through political liberalization. China, on the contrary, recorded early economic successes, which continued.

The economic structures could hardly have been more different in these two countries. The Soviet Union was overindustrialized, while three-quarters of the Chinese worked in agriculture. Soviet enterprises were predominantly large-scale and mechanized, whereas Chinese production was small-scale and manual. Chinese agriculture could easily be reformed through the introduction of quasi-property rights for peasants, which was impossible in the Soviet Union. Soviet industry was too big and distorted to be omitted, but it was also too powerful to be reformed.

From 1986 onward, the Soviet budget deficit exceeded 6 percent of GDP, and the country was heading toward hyperinflation, while China escaped macroeconomic destabilization, because the memory of hyperinflation in the 1940s and its cure were still in living memory. In the end, the Soviet Union collapsed, but China did not.

The situation in China and the Soviet Union differed in almost every political and economic regard. The problem was not that Gorbachev did not follow the Chinese lead but rather that he followed it too closely under very different preconditions.

How to Pursue Policymaking in the Midst of a Revolution

The critical insight from Russia's postcommunist transformation is that it was a revolutionary process with a characteristic radicalization. At the height of the revolution, from August 1991 to April 1992, most state institutions were suspended, and so were most social forces. This suspension offered policymakers a unique window of opportunity. During a short period of five months, truly radical measures were possible, but time was very scarce and state capacity minimal. The policymakers had to hasten to carry out key measures, which had to be sufficiently simple to be implemented in the chaos of revolution. Mistakes were inevitable, but the biggest mistake was to wait, because to wait meant to fail.

Adequate policymaking in a revolution requires six steps. First come ideas, which must be clear, simple, and relevant. Second, the ideas need to be translated into a set of policy actions. Third, the political leader takes the lead and makes an authoritative policy declaration. Fourth, the leader appoints a group of policymakers who can execute the reforms. Fifth, parliamentary support is necessary for substantial legislative work. Sixth, key policies must be implemented within this brief window of opportunity—"extraordinary politics," as Leszek Balcerowicz (1994) called it. International organizations can assist with advice and financing, but timeliness is crucial.

Why Did Market Reform Succeed?

Market reform succeeded in Russia because a critical mass of market reforms was implemented in the brief window of opportunity in the winter of 1991–92. The Yegor Gaidar team had a clear idea of how to build a market economy. President Boris Yeltsin supported this idea and presented it with a set of policy actions to the Russian parliament on October 28, 1991. The parliament approved of his program in a nearly unanimous vote. Yeltsin appointed a government of outsiders, young academic economists, who knew better than anybody else what to do. In January 1992 the reform government unleashed a sufficient mass of radical reform measures to render them irreversible, although they were insufficient for an early return to economic growth.

Until 1998, the economic results were poor because of lasting high inflation, inherited communist distortions, and too gradual reforms. Russia maintained a vast budget deficit averaging 9 percent of GDP from 1993 to 1998. Monetary policy was beyond the control of the reformers and very loose until the end of 1993. The inflationary ruble zone persisted until September 1993. The reformers failed to persuade Yeltsin to liberalize energy prices in early 1992. As a consequence, rent seeking prevailed, and high inflation persisted until 1996. The financial crash of August 1998 functioned as a catharsis that eliminated barter and the excessive budget deficit, cleansing Russia's market economy. Yet, the initial package of radical reforms was sufficient to ensure that the market economy survived.

Why Did Democracy Fail?

Democracy failed because of the absence of any clear idea of how to build it. Therefore, little was done in real life. The brief window of opportunity when a democracy could have been built was missed. Yeltsin should have dissolved the old, unrepresentative parliament within half a year after the aborted August 1991 coup, which delivered Russia's democratic breakthrough. He should have held an early founding election to stabilize Russia's democracy and disbanded the KGB. Instead, a major conflict evolved between president and parliament, and since the parliament did not really represent anything, it had no reason to compromise. Two years too late, Yeltsin dissolved the parliament, but it was recalcitrant and Yeltsin's administration inept, which caused serious bloodshed. The bloodletting stained Russia's nascent democracy.

A new constitution was adopted in a referendum in December 1993. It was democratic but suffered from numerous shortcomings. Presidential executive powers were excessive and not transparent. Powers between the federal and regional governments were not clearly divided. The Constitutional Court was weak. The parliamentary elections were not fully proportional, which left political parties feeble. The upper chamber, the Federation Council, became appointed and thus unrepresentative. Great, unregulated state powers and the weak rule of law prompted vast business funding of politics. President Vladimir Putin wanted to build an authoritarian state, and with these building blocks he could easily do so in the apolitical mood of postrevolutionary stabilization.

Early and Radical Reform Worked Best

A large number of early and radical reforms were effective, successful in achieving their objectives, and irreversible. Yeltsin disbanded the Soviet Union one week after the overwhelming Ukrainian vote for independence had doomed the Soviet Union, securing its peaceful dissolution. The price deregulation and liberalization of imports in January 1992 were accepted, worked, and were not reversed. Gaidar's drastic cut in military procurement in January 1992 defeated the military-industrial complex with surprising ease. Small-scale privatization was done fast and was not controversial. However, voucher privatization was controversial, but it transferred most enterprises to the private sector, and minimum renationalization has ensued. These reforms were successful because they were undertaken or at least initiated within the short window of opportunity. They also changed the paradigm, which made them credible and consistent.

By contrast, four gradual reforms were miserable failures. First, the early, loose monetary policy boosted inflation and harmed output. Second, the gradual dissolution of the ruble zone caused hyperinflation in 10 of its 12 constituent states in 1993. Third, the gradual hike in energy prices created one of the largest sources of rents the world has ever seen. Fourth, democratization was the most gradual and least successful reform.

The obvious conclusion is that under revolutionary circumstances little but radical reform is likely to succeed, and the earlier and simpler the better. The focus must be on principles and speed, not on details.

The Essence of Privatization Is Legitimate Property Rights

Private enterprise is nearly always better than public enterprise. Public enterprises breed corruption, monopolies, and subsidies, and if they dominate a country, neither democracy nor market economy can be maintained. Privatization has to be sufficiently fast to render the private sector dominant before the revolutionary moment is lost. At the same time, property rights must become legitimate to bar reversal. Enterprises are often bought and sold, which renders the original form of privatization increasingly irrelevant, while the extent and acceptance of privatization are vital. State revenues from privatization are immaterial, because successfully privatized companies soon pay more in annual taxes than what a perfect auction of them would have reaped.

The conclusion is that privatization has to be simple and undertaken in whatever way is politically acceptable, has to be done fast, and has to generate respect for the resulting property rights. That means Russia's combination of insider and voucher privatization was close to ideal. Any sale of big enterprises to outsiders was controversial, and such privatizations have been particularly exposed to renationalization. Considering that the remaining state enterprises easily instigate renationalization within that industry, state enterprises are like cancer that may cause metastasis. Hence, almost any privatization was better than no privatization.

Market Economy, and Renewed Democratization?

Russia has established a market economy with largely free prices and trade and predominant private ownership. It is an open economy. The business environment might not be great but is world average, and property rights are somewhat stronger (World Bank and International Finance Corporation 2006). The government is focused on maintaining macroeconomic stability and a high growth rate of 6.7 percent a year. In spite of some renationalization of big corporations, this market economic system is firmly set and does not appear threatened.

Politically, Putin's eight-year rule has been characterized by a systematic political deinstitutionalization and centralization of authoritarian power in his own hands. However, this is not a Soviet restoration. Ideology is conspicuously absent. Instead, Putin's authoritarian rule is reminiscent of long-past tsarism. Russia is simply too wealthy, educated, open, and economically pluralist to be so authoritarian. Either the market economy or the authoritarian rule will have to give in a not-too-distant future, and the market economic system appears much stronger than the still mild authoritarianism. Russia is likely to move toward a new wave of democratization.

The Structure of This Book

The structure of this book is chronological-thematic. It consists of seven chronological chapters and one concluding chapter with overall analysis. The first seven chapters may be seen as acts in a great revolutionary drama. Within each period, the main themes are analyzed.

Chapter 1, which covers the period 1985–87, presents perestroika, the great awakening. Gorbachev started perestroika because he believed in the Soviet system and wanted to breathe new life into it. Chapter 2 discusses the collapse of the Soviet Union. This period, 1988–91, saw a duel between Gorbachev, the moderate revolutionary, and Yeltsin, the revolutionary hero. Chapter 3 describes the revolution during 1991–93. Yeltsin oversaw the dissolution of the Soviet Union and a radical economic reform, but he did little to build a democracy.

Chapter 4, which covers the period 1994–95, is devoted to the rise and fall of the state enterprise managers, who were the initial victors of rent seeking and insider privatization. Chapter 5 deals with the period 1996–98, when the so-called oligarchs were dominant. The period ended with the dramatic financial crash of August 1998. Postrevolutionary stabilization followed the crash, as is discussed in chapter 6, which covers 1999–2003. Vladimir Putin became president in 2000, and he started centralizing power. In his second term, 2004–07, covered in chapter 7, Putin instigated more recentralization and built authoritarian rule. Chapter 8 offers major conclusions.