UIC Law Review

Volume 28 | Issue 4 Article 5

Summer 1995

Economic Reform and Economic Reality, 28 J. Marshall L. Rev. 847 (1995)

Judith Thornton

ECONOMIC REFORM AND ECONOMIC REALITY

JUDITH THORNTON*

INTRODUCTION

A little more than five years ago, the countries of Central and Eastern Europe launched their velvet revolution. Communist governments collapsed and their successors terminated the Warsaw Pact and Comecon trade system. Immediately, these countries began a progressive move toward Western institutions — parliamentary democracy, political pluralism, private enterprise and a market economy based on open commerce with the rest of the world. The former Soviet Union under Mikhail Gorbachev shared these changes in political and cultural life. May 25, 1989, marked the historic opening of the first representative assembly in Russia since the socialist revolution. Appropriately, Andrei Sakharov was one of the first speakers.

However, in the economic sphere, the progress of Russian reform has been halting and incomplete. The Shatalin Plan, adopted in September 1990 by the Supreme Soviet of the Russian Republic, was not adopted by the Soviet Union. Instead, the Soviet Union merged the plan with an administrative program drafted by the Ryzhkov government. The resulting melange of economic policies led to an unraveling of economic institutions, a breakdown of fiscal relations with the republics and a competition for ownership of assets that is still underway. In the end, the Soviet Union collapsed.

Today, the Russian economy is caught in the middle of an incomplete reform. Both Russian and Western attempts to implement a full complement of reform policies will fail unless they gain an understanding of what has happened so far.

During the last three years, Russia has attempted to build a new state, create the framework for civil society and establish the infrastructure of a market economy. These Russian accomplishments are impressive. Russia has dismantled much of the old administrative system, and a new entrepreneurial effort has appeared. However, Russia still misses many of the policies needed to support a market system. Instead, Russia has introduced policies that distort the adjustment process and raise the social costs

---

* Professor, Department of Economics, University of Washington.

of adjustment. These distortions of economic policy arise from the pressures of powerful elites who are competing for ownership and control of Russia's vast wealth and who can use destitute workers as hostages in the policy battle.

The Soviet collapse is associated with an enormous capital flight from the country and a transfer of assets and income from state ownership to the governmental elites who had exercised *de facto* control over resources. During the subsequent transition, Russian government policies, such as export quotas, licenses and central bank credits, have continued to foster corruption and subsidize capital flight. Sometimes, in an environment of unclear property rights and unenforceable laws, these policies privatize the revenue of economic activity, leaving the costs socialized.

The solution to this damaging halfway house of reforms is not more regulation. Instead, Russia must eliminate government policies that create rents and corruption. Russia must also implement policies that provide a stable environment for free market activity, financial stability, physical safety of citizens and clear enforceable property rights.

I. THE AGENDA OF ECONOMIC REFORM

The aim of economic reform is to provide a framework of laws and institutions that will further freedom and prosperity — to privatize, deregulate, liberalize and redirect the role of government. This will provide for social infrastructure and secure individual rights. Therefore, Russian leaders need to build a civil service that can function honestly and effectively. They need to create a legal framework that will secure individual rights and insure that individuals can advance their own welfare by being productive, undertaking mutually beneficial exchange and investing in the future. Moreover, the Russian leaders need to manage the risks and the costs of change in a manner that will maintain public consensus.

This process of economic reform involves many different steps. Russian leaders must create the legal, financial and administrative infrastructure for a private market economy; restrict government intervention in markets; adopt trade and industrial policies that will give domestic firms access to advanced technologies, investment and management skills. They must also create social policies geared towards labor that will not only accommodate innovation and structural change, but will also facilitate adjustment.

The establishment of clear, enforceable property rights is a key task in the reform agenda. The delineation and assignment of property rights is only one crucial part of the protection of human rights.

II. THE ROLE OF PROPERTY RIGHTS

Property rights are rules of the game that one may define by formal laws, administrative practices, or codify in an informal custom. These rules of the game define the forms that competition for resources may take in society. In Western practice, private ownership of an asset is associated with a number of rights. These basic property rights include the right to control, exclude, derive income or benefit and transfer. Ownership also implies the responsibility to bear the costs of one's actions.

The economist's understanding of property rights differs from the legal meaning. The economist does not focus on legal ownership. Rather, the economist focuses on *de facto* practice, which reflects costs of information and enforcement as well as legal rules.[1] Consider some examples of how person A might acquire some money from person B. Person A might steal it from person B, which would transfer ownership from person B to person A without compensation. Person A might say "Your money or your life" and threaten person B with violence or coercion. In this case, person A is transferring person B's rights to safety from person B to person A, but person A is offering person B the chance to buy them back for a price. Finally, person A might offer to sell person B something. Only in the third case are person B's property rights defined and enforced. Until person B's property rights are clear and enforceable, one cannot expect to see voluntary exchange. Why should a person trade with others when they may take what they want by theft or coercion without cost?[2]

If the protection of property is expensive, individual incentive to produce and hold resources is reduced. Therefore, wealth will be higher when property rights are clearly defined. If property rights are lacking, individuals will have to spend resources to secure ownership rights. All individuals have an incentive to use resources to acquire property. Without rules governing the protection of property, resources are wasted on the protection of ownership rights. This situation has existed in the former Soviet Union where, for the past five years, much of the entrepreneurial effort has focused on securing ownership.

---

1. An excellent textbook on economics that integrates property rights concepts into price theory is EUGENE SILBERBERG, PRINCIPLES OF MICROECONOMICS (1995). *See also* ARMEN ALCHIAN, ECONOMIC FORCES AT WORK (1977); Yoram Barzel, *Transactions Costs: Are They Just Costs?*, ZEITSCHRIFT FUR DIE GESSAMTE STAATSWISSENSCHAFT [JOURNAL OF INSTITUTIONAL AND THEORETICAL ECONOMICS], Mar. 1985, at 14-16.

2. "Without cost" presumably means without the pangs of conscience that most members of society would feel when they believe in a set of social rules that define the individual's right to property and personal safety.

Douglass C. North's *Institutions, Institutional Change and Economic Performance*[3] argues that institutional arrangements, both legal and *de facto*, shape economic performance by determining the full cost of producing and transacting.[4] North's definition of full cost includes both traditional economic costs and transactional costs of economic activity.[5] Transactions costs, which are the costs associated with finding ways to cooperate in spite of agency problems, including the costs of negotiating, enforcing and monitoring, are nothing more than the costs to establish and maintain property rights.[6]

Therefore, one advantage of a market system over an administrative system lies in the fact that the market allows not only competition among individual producers, but also competition among institutional forms. Individuals will attempt to find organizational forms that allow them to minimize the production and transaction costs of cooperating in economic activity.

Many of the differences between the performance of the transitional system and a market system arise because the constraints of administrative arrangements impose transaction costs on decision-makers. Additionally, the objectives of political decision-makers differ from market owners. For example, political administrators in the transition sometimes appear to maximize employment subject to constraints. Moreover, certain transactional costs, such as monitoring costs, may provide a benefit to the political elite, thus appearing as a benefit to political leaders, as well as a cost.

III. DEMOCRACY AND PROPERTY RIGHTS

While democracy and representative political institutions are desirable features of civil society in their own right, a democratic political process does not automatically secure individual rights to engage in voluntary market exchange. The United States Bill of Rights, not representative government and political pluralism, underpins our civil society and secures individual rights. This is the foundation that F. A. Hayek referred to as "the Rule of Law" in *Law, Legislation and Liberty*.[7] A similar listing of individual rights appears for the first time in the new Russian Constitution of December 1993. However, Russia is just beginning to establish the legal institutions to provide these constitutional guarantees for the individual rights enumerated in its new Constitution.

---

3. DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990).
4. *Id.* at 27.
5. *Id.*
6. SILBERBERG, *supra* note 1, at 295-325.
7. F. A. HAYEK, LAW, LEGISLATION AND LIBERTY (1979); *see also* F. A. HAYEK, THE ROAD TO SERFDOM (1944).

Property rights not only define an individual's right to create and use resources, they also delimit the ability to create and use an individual's own stock of skills and abilities (which the economist calls our "human capital"). If liberty is defined as the right to exercise full ownership of oneself, then *perestroika* means the restructuring of the rights to own and direct both oneself and the fruits of one's effort.[8]

Western tradition focuses on the role the rule of law plays in guaranteeing the rights of citizens when dealing with a powerful state that has a legal monopoly on the use of coercion. Nevertheless, as previously argued, citizens also lose some of their liberty — that is, their exercise of full ownership of self — when there is no means, through the state or otherwise, to safeguard their own physical safety.

While democracy, by itself, does not safeguard the rights of the individual from the "tyranny of the majority," representative government does allow log-rolling. Thus minorities are empowered by allowing them to trade votes. Still, while choice in markets allows diversity of consumption, political choice imposes uniformity. Whether one votes for the winner or the loser of an election, everyone consumes the winner.[9]

Real success has emerged from the entrepreneurial private sector in the Russian economy. Some of this success, no doubt, was built on the foundations of the informal sector of the former command system. However, Russia has failed to redirect the role of government from the exercise of ownership and regulation to the provision of public infrastructure. Russia has yet to make a credible commitment to private ownership. This deficiency is most apparent in the area of land ownership. Russia lacks legal infrastructure: law and order, justice, enforcement of contract and definition of property rights. It also lacks a tax-based fiscal system and the administrative capacity to fund and provide minimal municipal services such as pure water, roads, public safety and a social safety net for displaced workers. Russia has yet to determine the relative roles of local, territorial and central government or to build an honest, competent civil service.

With simultaneous market and government failure, the transitional economy suffers from many of the same distortions that prevailed in the administrative-command economic system that preceded it. In the transitional economy, the private sector some-

8. The importance of property rights to our exercise of freedom is, perhaps, clearest in the case of Chinese socialism, which gave the administrative institutions the right to direct individuals to a place of work and to define the conditions of their employment.

9. This is a key argument in MILTON FRIEDMAN & ROSE FRIEDMAN, FREE TO CHOOSE (1979).

times provides social infrastructure, such as security, that the government is unable to provide. Sometimes, small businesses pay protection costs to survive in a threat-based society.

IV. GORBACHEV'S LEGACY

Mikhail Gorbachev accomplished revolutionary changes in dismantling Russia's empire, in empowering civil society and in building representative political institutions. Nevertheless, his impact on the economy was disastrous. His economic policies further unbalanced an already distorted Russian economy.[10] His administrative measures to legalize cooperatives without freeing prices or providing legal markets for inputs created incentives to privatize state activities that were losing money, increasing state costs and diminishing tax revenues from profits. The anti-alcohol campaign further reduced the state revenues from turnover taxes.

The government's rising fiscal deficit led to a rapid expansion of the money supply with a growing differential between the government's set prices and the prices of goods in the informal market. Administrative organizations responded to growing "deficits of goods" by moving more of the supply of consumer goods into administrative allocation. At the same time, legalization of cooperatives reduced the cost and risk of shifting goods from state allocation into the black market and increased repressed inflation, causing black market revenue to rise and more goods to disappear into informal channels. With goods no longer available in the official market, increased government wages provided little incentive for increased effort by the workers.

In foreign trade markets, the regulations that allowed decentralized ministries to sell directly on the world market had unforeseen results. With access to hard currency officially blocked by the central government's monopoly of foreign trade, producers had incentives to set up foreign trade organizations and joint ventures that could sell Russian products on the hard currency market and hold hard currency abroad. In an attempt to control decentralized exports, there was an outpouring of presidential decrees, taxes and regulations between 1988 and 1991. However, all of these decrees were met with new forms of evasion.

Capital flight took place through strategies that were hard to detect in trade data. This occurred by underpricing goods that were delivered to the hard currency market and overpricing the returning imports. Measures adopted by the Soviet government in late 1990 to impose tariffs on imports and exports and require domestic firms to exchange 100% of hard currency earnings for

10. When he received the Nobel Peace Prize, his economic advisors reminded the press, quite rightly, that he had not received the Nobel Prize in economics.

rubles merely increased the incentive for capital flight. In real terms, the real quality of foreign imports returning to the domestic economy, including key industrial equipment, was reduced. Thus, shortages and bottlenecks began appearing in important sectors such as energy and transportation.

To an increasing extent, coordination failures disrupted supply. As strikes, work-stoppages, embargos and civil disorder interrupted production in key sectors such as energy, bottlenecks had a cascading effect on downstream sectors. Furthermore, the resources siphoned into the informal economy placed a further constraint on the ability of state enterprises to fill state orders. With growing repressed inflation and excess demand, firms and households stockpiled inventories of scarce goods, exacerbating existing shortages.

In response to the central government's growing inability to provide administrative supply of inputs, regions attempted to bring local products under direct regional control, bartering products with other regions and withholding the resulting revenues from the center. The devolution of authority and ownership between the center and the regions contained at least three aspects: the expression of national and ethnic interests; a devolution of political power to the regions and republics; and most importantly, a competition for ownership of lands, resources and productive assets of the former Soviet economy.

On the eve of the collapse of the Soviet economy in December 1991, Mikhail Gorbachev left Russia and the emerging republics with an unraveling economy characterized by:

— falling production,
— a large ruble overhang,
— diversion of resources to illegal markets and to capital flight,
— corruption,
— a $103.9 billion international debt,
— a collapse of trading links with former partners,
— a collapse of fiscal revenue, and
— a government deficit larger than thirteen percent of GNP.

V. TRENDS IN PRODUCTION

In January 1992, Russia faced the challenge of forming a new state, creating civil society and establishing the institutions of a market economy. Russia never underwent "shock therapy," if that term is defined as a concerted policy of reducing the federal budget deficit and slowing the growth of central bank credit to firms that were losing money. Russia did experience a shock of price liberalization in January 1992, but economic disorder in the subsequent four years stems from other sources. Conflict existed between the executive and legislative branches of government and between the federal and territorial governments. Factions competed for control and ownership of valuable assets. Trade with Eastern Europe broke down, much of which did not serve the interests of the trading partners at world prices. Finally, the economic and political arrangements of the newly independent republics were in disarray.

Falling production had already begun in 1990, when the energy sector suffered equipment shortages and strikes. Then, in 1991, trade with Eastern Europe collapsed. Further steep drops in officially measured GNP and industrial output occurred in each of the next four years. By the end of 1994, according to official figures, real industrial production was at fifty-seven percent of December 1991 and GNP was at half of earlier levels.[11] Real wages in state firms fell to half their former levels during the 1992 explosion of inflation, before beginning a gradual recovery. In 1994, real disposable monetary incomes of the population, corrected for price change, increased by nineteen percent over the previous year.[12]

Official production figures that once had an upward bias now understated real performance. The private sector that has emerged supplies an estimated forty percent of consumer goods. Declining production of military hardware for domestic use has minutely affected real consumer welfare, while consumers could enjoy real benefit from a reduction in the output of value-subtracting products and the export of the inputs thus freed into the world market. Exports of raw materials in exchange for foreign consumer goods has given consumers access to improved quality and variety at improved terms-of-trade, although raw materials exports have financed capital flight as well. Still, a one-third reduction in Russia's real production between 1990 and 1995 is immense, and the distribution of that decline is unequal between regions and social groups.

While commercial cities like St. Petersburg, Moscow and Vladivostok show evidence of thriving international trade and new construction, other cities that were centers of the military industries, such as Tomsk, Magnitogorsk and Chelyabinsk have a bleak future. While young, English-speaking business school graduates enjoy unprecedented opportunities, mature workers who lost their lifetime savings in Russia's inflation, face the future with neither private savings nor a social safety net.

11. Center for Economic Reform, Government of the Russian Federation with the assistance of the Center for Economic Performance, London School of Economics, RUSSIAN ECON. TRENDS (Supp. Jan. 17, 1995) [hereinafter TRENDS].

12. *Economic Statistics*, DELOVOY MIR, Dec. 4, 1994, at 4.

VI. MACROECONOMIC TRENDS

In contrast to success in liberalizing markets and privatizing production, macroeconomic performance has been dismal. Consumer prices jumped 300% with price liberalization in January 1992. After that, monthly price inflation declined gradually during the first half of that year but picked up again as monetary policy became expansionary in the second half of the year. Double-digit monthly rates of inflation (in excess of twenty percent per month) persisted until the fall of 1993, when the Ministry of Finance resorted to sequestration to avoid hyperinflation. In the first three quarters of 1994, inflation slowed to seven percent monthly, but expanding subsidy payments fueled rapid monetary expansion and rising inflation again in the fourth quarter of 1994 and in early 1995.[13]

Price inflation has followed the ups and downs of fiscal and monetary policy closely. Enterprise arrears rose whenever both fiscal and credit policy were tightened. For example, during the first half of 1992, when the government reduced subsidies and cut expenditure and the central bank also slowed the growth of credit, enterprise arrears spiraled up as firms continued to ship goods to nonpaying customers. In July 1992, when the Supreme Soviet replaced central bank chairman Matiukhin with Mr. Gerashchenko, a deluge of subsidies and directed credits from the Central Bank and Treasury equal to more than half of total GNP were paid out to favored constituencies.

Tax revenues, which totaled roughly twenty-nine percent of GNP in 1992 and 1993, fell to less than twenty-five percent in 1994 as sectors, such as energy, received tax exemptions. The Russian government's agreement with the IMF on the 1995 Budget promises increased tax collections and reduction of the Budget deficit to roughly seven percent of GNP. However, Russia was unable to hold to three previous stabilization agreements. So, with parliamentary elections coming up in December 1995, it is hard to predict how the Russian government will respond as pressures for soft credits continue to mount.[14]

VII. FOREIGN TRADE

In spite of genuine attempts at trade liberalization by Gaidar's reform administration, foreign trade remains the single

13. Vincent Koen & Michael Marrese, Stabilization and Structural Change in Russia, 1992-94, Paper Presented at The Allied Social Science Ass'n Annual Meeting 6-7 (Jan. 6, 1995) (on file with author).

14. *Institute of Economy in Transition*, 3 REV. OF THE RUSSIAN ECON. 75 (Sept. 1994) [hereinafter RUSSIAN ECONOMY].

most important source of governmental corruption and regulatory inefficiency. In 1994, barter agreements accounted for almost one-third of Russian trade — notably, trade with China. Today, Roscontract, the state trading agency that evolved from the former Soviet foreign trade ministry, still employs about 500,000 people.

Gaidar's reform government unified Russian exchange rates and established convertibility in August 1992. However, import subsidies remained large and export quotas continued to apply to the most important export commodities. The government required exporters to repatriate fifty percent of export receipts at the interbank rate of exchange. However, the government allowed many exemptions and much hard currency remained offshore. Beginning in January 1993, the government purchased a share of the oil and gas quotas at low ruble prices and received the foreign exchange from the sale on the world market. The Russian government also delivered foreign humanitarian aid as directed credits to constituencies within the economy rather than selling it on domestic markets. Because of export quotas and taxes, domestic prices of energy and exportable raw materials remained substantially lower than world prices. In 1994, domestic oil prices actually fell from an average of forty percent of the world price to about one-third of the world price.[15]

Between 1990 and 1994, Russia's foreign trade with the former republics collapsed along with domestic production. Both Russian deliveries to the republics and imports from them fell to less than half of their former level, if deliveries are aggregated with a set of constant prices. But comparison of the size of inter-republic and world foreign trade is fraught with difficulty due to the collapse of the ruble's value from 197 rubles per dollar in January 1992, to 1,444 rubles per dollar in January 1994, to 4,780 rubles per dollar in March 1994.[16]

Trade outside the former Soviet Union fell much less. Exports that had been sixty-three billion dollars in 1990 fell to forty-two billion dollars in 1992 and recovered to about fifty billion dollars in 1994. Imports from outside the region dropped from a 1990 level of fifty-three billion dollars to thirty-seven billion dollars in

---

15. *See, e.g.*, Vladimir Konovalov, *Russian Trade Policy*, *in* TRADE IN THE NEW INDEPENDENT STATES, 29-51 (Constantine Michalopoulas & David G. Tarr, eds., 1994); RUSSIAN ECONOMY, *supra* note 14.

16. For example, valuing Russian inter-republican deliveries at 1990 world prices, PlanEcon estimates that Russian deliveries to the republics would have generated a trade balance surplus of $15 billion in 1994 evaluated at 1990 world prices. Valuing these same deliveries at 1994 prices, PlanEcon estimates that Russia ran an export surplus with the republics of about $1 billion during the first half of 1994. *See* PlanEcon, Inc., Review and Outlook for the Former Soviet Republics 22-23 (Mar. 1995) (unpublished monograph, on file with PlanEcon, Inc.).

1994 — a positive trade balance outside the region of eleven billion dollars.[17] Russia's principal world exports were crude oil, petroleum products and natural gas which paid for imports of food, consumer goods and equipment. In 1994, Russia's top trading partners outside the region were Germany, the United States, the United Kingdom, Italy and China.[18]

The surprising development is the size of Russia's export surplus during this whole period. Russia's export surplus, reported by the Russian government, was \$4.2 billion in 1992, \$16.8 billion in 1993 and \$13.7 billion in the first three quarters of 1994.[19] Western observers speculate that there is actually a substantial hidden import of products that escapes official statistics, while Balance of Trade estimates provided by the Institute of Economy in Transition, the Egor Gaidar Institute, posit that there are offsetting short-term capital outflows.[20] In either case, it is difficult to understand why the Russian government is unable to access hard currency receipts that continue to rise both domestically and abroad.

Russian international indebtedness continued to build up after the collapse of the former Soviet Union. At the end of 1993, Russian and Soviet foreign debt had increased to about \$119.3 billion, including official and guaranteed debt of about fifty billion dollars, due to net borrowings from international institutions and interest arrears. Russia's debt is comprised of former Soviet debt which Russia assumed.

During 1993 and 1994, Russian officials met regularly with representatives of Western creditor banks and negotiated rescheduling agreements on principal and interest arrears in Russia's debt with commercial creditors. In addition, in 1993, the Russian Ministry of Finance began issuing domestic convertible-currency bonds which it must service. The Ministry of Finance issued these bonds to cover domestic convertible currency deposits of the Soviet foreign exchange bank which currency holders lost when the Soviet Union collapsed. Ministry of Finance bonds trade on the fledgling Moscow International Commodities Exchange, but the small size of Russia's emerging capital market and the continuing inflationary environment limit Russia's access to financial markets, even at high interest rates.[21] In March 1995, the IMF agreed with Russia to extend a \$6.4 billion structural adjustment loan after the Russian parliament approved a tight budget and President Yeltsin promised to end widespread exemptions from tax

17. *Id.*
18. TRENDS, *supra* note 11, at 75.
19. *Id.* at 74-78.
20. RUSSIAN ECONOMY, *supra* note 14.
21. PlanEcon, Inc., *supra* note 16, at 29.

obligations for exporters.

VIII. THE FOREIGN TRADE REGIME

Russia's trade regime is highly regulated. Initially, the cornerstones of trade policy were export quotas combined with import subsidies. Gradually, Russia has moved to a consistently protectionist set of policies — import tariffs, export taxes, export quotas, licensing and state trading at subsidized prices. Both access to quotas and exemption from taxes generates substantial rent-seeking behavior. Tax exemptions for energy exporters — notably for Gasprom — appear to be a major source of decrease in government tax revenues that may be as large as five percent of Russian GNP.

Domestic policy statements justify trade protection by emphasizing the immense gap between Russian relative prices and world prices at the time that trade was liberalized.[22] Energy and raw materials users argued that domestic firms in energy-intensive manufacturing could not survive if faced with world prices for their inputs. Export taxes were also viewed as a way of centralizing the collection of economic rents on natural resources in the hands of the federal government.

On the export side, quotas were the single most important restriction on the trade regime. Although the Russian government eliminated some non-energy export quotas in mid-1994 and on oil beginning in January 1995, the remaining restrictions — licensing of firms with export rights, export registration, tariffs and special controls on military technology — continue to restrict export activity.

Export quotas applied to most energy and raw materials, which accounted for almost three-quarters of total trade. They were based on material balances calculated by the Ministry of Economy that projected the difference between domestic use and production. The Ministry of Foreign Economic Relations distributed most export quotas as follows: fifty to fifty-five percent to Roscontract (the centralized trading organization), thirty percent to enterprises, ten to twelve percent to territorial administrations and three to five percent for sale through auctions. Exports produced by joint ventures were not subject to quotas. Given the enormous profits to be made from domestic and world price differentials, it is not surprising that their distribution was the subject of intense rent-seeking.[23]

22. *See generally* Sergei Glaziev, *The Origins of Russian Trade Policy*, *in* TRADE IN THE NEW INDEPENDENT STATES 59 (Constantine Michalopoulos & David Tarr, eds., 1994).

23. *See* Konovalov, *supra* note 15, at 41-43.

Elimination of export quotas in 1994 should have resulted in higher domestic energy prices, a strengthening of the exchange rate through higher export proceeds, less rent-seeking and increased budget revenue from excise taxes. The fact that none of these changes has appeared suggests that export policy remains highly regulated.

Export taxes are levied on almost all natural resource and semiprocessed goods. Most tariffs, which are stated in ECU's per ton are equivalent to value taxes of twenty to eighty percent. Oil and gas are subject to rates of thirty-four and twenty percent. In addition, the government imposes surcharges of approximately fifty percent on all barter trade and on some joint venture trade in order to penalize exporters who avoid implicit foreign exchange surrender taxes.[24]

Only registered exporters may export many goods, mainly raw materials. About 200 foreign trading organizations and large enterprises may export registered goods. All other exporters must work through these registered exporters.

In addition, centralized government trade, especially in energy and fuels, continues to account for about nine billion dollars of total exports. Initially, the net receipts earned from centralized trade financed centralized imports, which were distributed to the economy as off-budget subsidies. Now, the government supposedly directs the net receipts of centralized exports to service external debt and provide budget revenue.

Since 1993, Russia has imposed gradually increasing import tariffs as well. In late 1994, import rates were forty to forty-six percent on cars, sixty percent on computer components, twenty-five percent on machine tools, ten percent for agricultural products and twenty percent for apparel. A twenty percent value-added tax also existed on imported goods.

The sheer size of the Russian economy suggests that an active financial market would emerge if Russia could stabilize its currency and put in place improved legal and financial infrastructure for business. A core of the Russian financial sector is developing at a breathtaking speed. However, in spite of highly visible direct investment from corporate giants like ABB and active involvement of investment funds, like the Russian-American Enterprise Fund, total foreign investment in Russia remained less than three billion dollars in June 1995 — only a fraction of foreign investment in China or, even, Viet Nam. Continued capital outflow by Russian industrial groups signals that even well-placed Russian industrial elites chose to hold much of their portfolio outside of Russia, although increased in-flow appeared in mid-

---

24. *Id.* at 43; RUSSIAN ECONOMY, *supra* note 14, at 164-79.

1995.

IX. PRIVATIZATION

The most important development that could elicit a repatriation of flight capital is Russia's privatization program. Russia has made significant progress in privatizing production despite persistent macroeconomic instability and declining industrial output. Since 1992, the leadership has liberalized most domestic prices and foreign exchange markets and has undertaken mass privatization of both small-scale service activities and large-scale industrial firms. By the end of 1994, approximately 130,000 enterprises were privatized or leased with a purchase option.[25] This number represents more than half of the 250,000 state and municipal enterprises operating in 1992.

Russia privatized three fourths of small-scale trade and service enterprises, usually through auctions or tender offers. Employees purchased most of these on concessional terms. In addition, Russia has registered more than a million new small private businesses, and a large, unofficial private sector has emerged.[26]

Voucher privatization began in December 1992, and ended in July 1994. This process involved employee buy-out and the sale of enterprise shares in voucher auctions. By mid-1994, Russia had privatized 13,500 firms employing more than sixteen million workers and more than forty million Russians were stockholders in joint-stock companies or in investment funds.[27] Most voucher privatization resulted in effective insider control of firms, with worker shares serving as a "poison pill" and raising the costs to outsiders of acquiring enterprise control. In regions with valuable assets, especially firms with hard-currency exports, local elites undertook a variety of strategies in order to retain ownership of assets in competition with outside financial groups who controlled sufficient rubles or vouchers to acquire controlling stakes.

Starting in the second half of 1994, government holdings of enterprise shares have been on offer for cash, and shares in some large firms have been sold to strategic foreign investors. In 1995, a financial market for government debt and enterprise shares emerged in spite of continuing inflation at high, but declining monthly rates. The Russian government forecasts a revenue of nine trillion rubles from privatization proceeds during 1995.[28]

The government is negotiating a plan that would give a consortium of Russian banks the management of the government's

---

25. Koen & Marrese, *supra* note 13, at 15.
26. TORGOVAYA GAZETA, Dec. 28, 1994, at 2.
27. Koen & Marrese, *supra* note 13, at 15.
28. TRENDS, *supra* note 11, at 9.

stake in major exporting and utility firms — Gasprom, the nation's oil companies, Norilsk Nickel, Rostelecom (the telecommunications firm) and UES (the electricity monopoly). In exchange, the banks would lend the government money to help cover its budget deficit. The proposed loans by some of the largest banks — Imperial, Menatep, Oneximbank, Stolichny and Inkombank — would reduce the incentive of the government to tax exporters and would foreclose foreign participation in these firms.

About one-third of apartments and some 300,000 farms were privatized, and a majority of citizens took advantage of opportunities to purchase small, rural private plots. However, the share of land in private hands remained at about five percent of the total, while restrictions on the full exercise of land ownership reflected the ambivalence of leaders and the population to the capitalist notion of private property in land. Without land title and a developed legal infrastructure to enforce contracts, the capital market has much uncertainty. However, Russian financial-industrial-groups have emerged from the old administrative structures. These business groups form long-term relationships based on collateral held in hard-currency markets or on informal relationships based on reputation and long-term association.[29] But such informal business links cannot substitute for missing political stability and legal infrastructure.

X. Barriers to Russia's Transition

Why has Russia been unable to build the legal and financial infrastructure of a market economy? Current political instability shows that the population is deeply divided on the desirable features of a future economy. Moreover, Russia needs an immense structural adjustment if it wants to find a new role in the world economy. At the time of the collapse of the former Soviet Union, economic structures were deeply distorted. Moscow's ministries had deliberately fragmented production processes to assure their key role in coordination. Implicit taxes and subsidies confronted decision-makers with the wrong costs and prices. Thus, when Russia opened to the world market, most workers were in the wrong places doing the wrong things. These workers still in the same position today.

How can Russia accomplish the structural change that could potentially eliminate whole cities the size of Magnitogorsk? Currently, only a rudimentary labor market exists. One major constraint on a functioning labor market is the difficulty of creating a housing market. Without legal ownership of land or credit mar-

29. I am indebted to Evgenii Kuznetsov for much of my understanding of the significance of these informal arrangements.

kets, it is still difficult to expand the stock of housing in growing regions. Residential construction is an exception to the collapse of investment activity, but experts estimate the government regulatory environment will triple the cost of new housing. Further, without an adequate social safety net in place, can the government afford to end the subsidies that prop up state firms losing that are money?

The central government is weak and segmented. Territorial governments reflect the influence of territorial elites who must bargain with the center for control of local resources and assets. On the other hand, these elites must protect their control of local enterprises from encroachment by outside financial groups whose capital originates in trade and financial operations on the world market. The center has subsidized the activities of these outside financial groups through access to quotas or access to Central Bank credit at subsidized interest rates.

Today, the political competition at the center is no longer between economic reformers and party officials. The foundations of private ownership and the need to integrate into the world market seem to enjoy widespread acceptance in the parliament and among industrial managers. However, there is a new division between the elites who control the exporting industries and the groups who will be uncompetitive in a Western-oriented market. The exporting groups, such as producers of oil and gas, favor a quasi-open market (with continued opportunities for rent-seeking) and access to Western technology. The closed-economy group, which includes the military and energy-intensive manufacturing, favors tight governmental restrictions on export, redistribution of export rents to the military and restructuring of uncompetitive manufacturing, high import protection, and strong restrictions on foreign investment or participation of foreign companies in Russia's domestic economy.

These groups have come to a considerable consensus. Neither wants free trade; even the exporters want export quotas to create a price differential between domestic and world price and provide rents to exporters. Both want tight corporatist relationships between industrial managers and government administrators to maximize the opportunities for rent seeking. But each group wants to control the government apparatus in order to structure government policies in its own interest. If the first group is believed to have the ear of Prime Minister Chernomyrdin, the former head of Gasprom, then the second group is believed to have the ear of Oleg Soskovets, Russia's first deputy prime minister and Yury Skokov. Meanwhile, a new oil exporting organization, Rostoplivo, has been licensed under the ownership of the Presidential Staff Administration of Affairs, headed by General

Korzhakov.[30]

XI. PROSPECTS FOR REFORM

A stalemate has appeared between the executive branch of government and the parliament, so the likely short-run mix of domestic policy will reflect the influences that have prevailed in the past year. Groups seeking to use the government as a channel for redistribution of resources will create enormous rent-seeking activity. The close corporatist relationships between government and industry that we have seen in the past will persist, and the Treasury and Central Bank will have a difficult time trying to balance the budget and to resist continued pressures for subsidies.

The IMF, World Bank and Western countries will continue to press for stabilization and a social safety net and attempt to assist in establishing market infrastructure. But the resources that they can bring to bear are small relative to the size of Russia's problems. Gasprom appears to have more resources at its disposal to assist Russia than does the IMF. Russia's tax revenues will continue to dwindle unless the government eliminates tax exemptions.

In a highly uncertain environment, many possible scenarios could occur with some positive probability. An optimistic scenario would involve the Russian government and legislature working together within the framework of the new Russian constitution and with the help of international organizations to achieve macroeconomic stabilization and build the legal and financial infrastructure of a market system. In this scenario, territorial administrations would gain the right to spend local taxes on the construction of local infrastructure, and citizens would gradually acquire the information and the ability to monitor public officials.

During the first half of 1995, Russian government policies limiting the budget deficit, restricting credit expansion and pegging the value of the ruble to the range of 4,300 to 4,900 rubles per dollar improved the chances that an optimistic scenario based on macro-economic stabilization can be achieved. If economic stabilization and political stability are achieved, the new owners of Russia's wealth will see the market valuation of their assets begin to rise from current, highly discounted levels. Thus, there is reason to hope that elites in the exporitng industries, such as oil and gas, will support economic stabilization out of self-interest. Stabilization would also allow flight capital to return in the form of productive investment, another optomistic development. It is less clear that these same elites would find it in their interest to eliminate the export regulations and tax exemptions that underpin

---

30. IZVEVESTIIA, Feb. 1, 1995, at 2-3.

their rents. Moreover, it remains to be seen whether a government run in the interest of an exporting elite would be validated by voters in the coming parlimentary and presidential elections.

Of course, many less attractive scenarios, each of which has a low probability, could occur. Russian political life might take on a nationalistic tone, and resource rents and foreign exchange revenues might support renewed Russian expansion into its "near abroad." Military spending would expand again. In this scenario, the government would re-nationalize the oil industry, limit foreign firms in the energy sector to service contracts and assign former military research and development establishments the task of developing new submersible offshore oil platforms.

In another unfortunate scenario, Russia is unsuccessful in containing the level of corruption and crime. In this scenario, bankers and foreign business people travel with armed guards, and the Russian parliament continues to lose deputies to violence. In a closely related scenario, Russian military confrontation in the Caucuses spills over into terrorist incidents, so Russia establishes martial law in the major cities. Hopefully, these scenarios also have a low probability.

A third undesirable scenario, which has a reasonably high probability if clear ownership rights are not established quickly, is the decapitalization of assets and the destruction of Russia's natural resource base. In this scenario, the salmon runs on Kamchatka disappear and a loan officer from the EBRD, who is sent to Khabarovsk to provide due diligence for a proposed plywood plant, discovers that the territory cut down its last tree in 1995.

The loans that are currently on offer to the Russian government from powerful banks would be secured by ownership of Russia's major raw materials exporting firms. But this would not create a genuine capital market. To the extent that stabilization is achieved, political and economic instability reduced and market infrastructure introduced, a genuine, decentralized Russian domestic capital market will be established, and foreign investment will begin to return. If a more stable market-friendly environment is not put in place, then we can expect an asset stripping of Russia's capital and resources, continued brain drain, and deterioration of the social environment in regions that are bearing high adjustment costs.

The future of Russia's economy could take many forms. However, the shape of Russia's future will depend crucially on whether it can establish the rule of law, build the institutions of a market economy and limit rent-seeking by powerful elites. Otherwise, Russia's reform will not serve the welfare of its people.