

THE FIRST TEN YEARS OF ECONOMIC REFORM IN POST-SOVIET

RUSSIA: OUTCOMES AND POLICY ALTERNATIVES

by

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ABSTRACT

Russia's renewal since the collapse of communism has proved extraordinarily difficult and uneven. While the political dimension of post-Soviet reform has for the most part succeeded, the economic aspect of the reform has failed. This project argues that the radical economic reform carried out by the Yeltsin government was doomed to failure, because the design of the reform was unsuitable, and its implementation unsatisfactory. The central thesis of this project is that Russia had no institutional preparation for a rapid transition to a market economy of liberal orientation; a wrong policy choice has been the main reason for the unsuccessful outcome of Russian economic reform.

To analyze the issue of Russian post-communist reform and its outcomes, this project uses the case study method. The paper critiques the "shock therapy" approach as a strategy of economic transformation and suggests an alternative set of policy options based on gradualism and social-democratic values, arguing that the latter strategy holds a better prospect of generating sustainable economic growth.

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[The] reform secured macroeconomic change, namely the destruction of the old economy. It was a wildly painful break, surgically crude, with the rusty grinding sound of pieces of old parts and mechanisms being ripped out together with the flesh....[That economy's] make-up dictated precisely that sort of a break: over the knee.

-Boris Yeltsin¹

Sudden action is for those who do not themselves suffer, do not think before acting, who proceed by formula, not fact. Only if time is allowed can there be time for thought - the thought that is attuned to pragmatic result and not to primitive ideology.

-John Galbraith²

1. Introduction

It appears that most observers agree on the outcomes of the first decade of economic reform in post-Soviet Russia, outcomes that could be rather effectively summarized by a single word - failure. The above results can also be easily summarized in one sentence: "during the twentieth century, no country in the world suffered in peacetime such an economic disaster as did Russia in the 1990s."³ The economic and social crisis went far beyond any reasonable expectations in regard to the levels of anticipated transitional recession. What is much less clear from the diverse literature on Russian transition is what might have been the causes explaining the above results, and what lessons are to be drawn from the experience.

As Job⁴ shows, two models of explanation emerge from the mainstream economic analysis of post-communist Russia. According to the first way of explaining the situation, no extraordinary events have happened in the country; the road to the market

¹ Boris Yeltsin as cited in Richard Sakwa, Russian Politics and Society (London: Routledge, 1996) 231.

² John Galbraith as cited in Peter Nolan, China's Rise, Russia's Fall: Politics, Economics and Planning in the Transition from Stalinism (New York: St. Martin's Press, 1995) 57.

³ Oleg Bogomolov, "Russia Facing the Challenges of the Twenty-First Century," International Social Science Journal, Vol. 52 Issue 163 (March 2000): 95.

⁴ Sebastian Job, "Globalizing Russia? The Neoliberal/Nationalist Two-Step," Third World Quarterly, Vol 22, N. 6(2001): 931-947.

goes naturally through economic depression and social instability, difficulties that are only temporary “potholes” on the road to the market. In other words, within this “minimizing theory” framework, both economic and social costs are seen as a necessary price to pay for the opportunity of switching to the free market economic arrangement; the burdens of the reforms are to be borne for the sake of inevitable success.

Another theory explaining the difficulties of the transition is that of Russian “exceptionality” or backwardness. According to this school of thought, it is historical, cultural, and national peculiarities that explain the failure of economic reform in the Russian context; it was the lack of democratic tradition, the lack of understanding of the market’s basics, the lack of an appropriate work ethic, the lack of the rule of the law, etc., that determined the post-Soviet failure. This emphasis on Russian exceptionalism, although having some merit, can nonetheless be seen for the most part as an effort to avoid any serious questioning of the neo-liberal formula for reform.⁵

This essay will argue that the failure of Russian economic reform cannot be adequately explained by either of the above theories; instead, it is the structural adjustment policies within the larger framework of the neo-liberal development strategy adopted by the Russian government in 1991-1992 that lie at the core of the country’s unprecedented economic and social decline. Another major separate factor in Russia’s fall has been the country’s incompetent and often self-interested political elite and its uncritical and doctrinaire adoption of liberal policies combined with its surrender to the pressures from oligarchic groups.⁶

Were there any feasible alternatives to the radical economic model adopted by the

⁵ Job 932.

⁶ Sergey Braguinsky and Grigory Yavlinsky, Incentives and Institutions: the Transition to a Market Economy in Russia (Princeton: Princeton University Press, 2000) 200.

Russian administration in 1992? Another argument advanced in this paper is that it is not the neo-liberal, but the social-democratic path that the Russian administration should have chosen at that time. It would have been easier to move from state socialism to a socially-oriented mixed economy - most elements of institutional infrastructure of social democracy were already in place; there was no need to dismantle them.⁷

Finally, is there any place for an alternative strategy for contemporary Russia? While the social-democratic alternative remains a strategy that would be the most beneficial to the vast majority of the country's population, both the institutional capacity and the economic ability to support a welfare state have been seriously weakened. Thus, at this stage, a welfare state with full employment with free health care and education is simply unaffordable and out of reach. This does not mean, however, that no elements of a progressive economic program of modernization and development can be adopted at this time. If the recent trends of economic and social degradation are to be overcome and reversed, it is essential that efforts are made to develop and promote a reasonable economic strategy appropriate to Russian conditions, a strategy that would produce growth without disrupting social stability. This strategy, while accepting the market system as the best way of organizing the production of goods and services, will aim to use state institutions to ensure that the benefits of this system are distributed in a way that ensures the maximum benefit for all groups of society. This progressive strategy of social-democratic orientation would call for finding a new, country-specific balance between the free market and state regulation, and would call for the state becoming more active, efficient, and predictable while less bureaucratic.

To analyze the issue of the Russian post-communist reform and its outcomes, this

⁷ Bertram Silverman and Murray Yanowich, New Rich, New Poor, New Russia (London: M.E. Sharpe, 2000) 25.

project uses the case study method and more specifically a *process study* research design in terms of Louise White's classification of case studies;⁸ this type of research design is commonly used in examining public policies.⁹ The case study investigates the following two propositions: (1) an inappropriate economic development strategy has been adopted by the Russian government which has resulted in economic and social decline on a large scale; (2) the country could have done better had it chosen to pursue socially oriented, incremental market reforms of socio-democratic orientation.

The first part of this project will examine the neoliberal economic reform adopted by the Russian government in 1991-1992, focusing on implemented policies and their immediate effects and long-term outcomes. The second part will suggest and analyze the reasons for the failure of post-communist reform. The final section will discuss the elements of a transition to a socially oriented market economy and offer some alternative policy proposals.

2. Economic reform and its outcomes

Perhaps the best way to approach the task of analyzing Russian post-communist reform would be to look at the process in a historical perspective, starting with the policies introduced by the Gorbachev administration in 1986 followed by the strategy adopted in 1991 by the Russian government led by Yeltsin. In this section we will also consider the policies implemented in 1991-1992 within the framework of radical economic reform, and their immediate and long-term outcomes.

⁸ Louise G. White, *Political Analysis: Technique and Practice* (Fort Worth: Harcourt Brace College Publishers, 1999) 101-121.

⁹ White 118.

2.1. *Evolution of economic reform*

Soviet socialism never found an effective economic policy; the Soviet system stormed into the industrial age but failed to respond to the challenges of post-industrialism.¹⁰ As a result, starting in the late 1960s, the Soviet Union had been increasingly lagging behind the leading Western countries in regard to all the major economic indicators; by the mid-1980s, it became obvious that the Soviet administrative-command system was no longer capable of producing the results necessary for adequate economic development.¹¹ The Soviet centrally-planned economy failed for three major reasons: central planning required an enormous amount of information, which was not always available and was often out of date; a supply-dominated economy had a built-in tendency to supply what the centre wanted to supply, rather than what consumers would prefer; and finally, the operation of the planned economic system did not reflect relative scarcities, making optimum economic decision-making impossible.¹² Reform of the country's economic institutions was therefore both necessary and inevitable, even though the situation in the early and mid-1980s can best be described as that of stagnation rather than of economic decline.¹³

The reforms instituted by Gorbachev in the late 1980s could be viewed as a response to the crisis of an administrative-command economy managed from the centre. These reforms could be summarized as follows: the growth and legitimating of market transactions; an increase in private and cooperative trade; a greater authority given to production units; adoption of the accounting principle of *khozraschet* whereby units had

¹⁰ Richard Sakwa, *Russian Politics and Society* (London: Routledge, 1996) 231.

¹¹ Anders Aslund, *How Russia Became a Market Economy*, (Washington, D.C.: The Brookings Institution, 1995) 41-50.

¹² David Lane, *The Rise and Fall of State Socialism* (Cambridge: Policy Press, 1996) 101.

¹³ Nolan 40, 303, 304; Marie Lavigne, *The Economics of Transition: From Socialist Economy to Market Economy* (St Martin's Press: New York, 1999) 45.

to balance their income and expenditure; and the reduction of the central bureaucracy while giving greater autonomy to the republics.¹⁴ The new economic model proposed by Gorbachev and his advisers not only rejected the bureaucratic command structure in favour of the market; it also abandoned the assumption that state ownership was the only acceptable form of common ownership, adding new forms of cooperative and individual ownership.

How much should have been planned by the state, and how much left to the market, according to Gorbachev's economic paradigm? While Gorbachev and his administration rejected the extreme ideas of neo-liberal economics, including proposals to close down all loss-making farms immediately and let prices rise until supply equals demand, he did not commit himself to the continuation of direct administration of production and investment by the state.¹⁵ Thus, he pointed out that the state management

... will be freed from the functions of direct interference in the operational administration of economic units and concentrated on the establishment of general normative frameworks and conditions for their activity. Its natural spheres will remain: the key directions of scientific and technical progress; the infrastructure; the defense of the environment; securing that people are adequately supported socially; the financial system, including its instruments of taxation; and economic legislation, including legislation against monopoly and its negative consequences for society.¹⁶

It is evident that Gorbachev and the moderate reformers around him were aiming at a democratic, politically pluralist form of social democracy with a mixed economy, a strategy that has had a reasonable potential for producing growth without disrupting social stability. However, in the Russia of the late 1980s - early 1990s, there was another political power centre: most of the ruling party-state elite of the Russian Federation, influenced by the radical version of liberal economic theory and often motivated by their desire to achieve the prosperity of its Western counterparts, became the centre of a

¹⁴ Lane 107.

¹⁵ Davies, R.W., "Gorbachev's Socialism in Historical Perspective," *New Left Review* 179 (1990) 14.

¹⁶ Davies 15.

coalition led by Yeltsin.¹⁷

Radical reformists became the chief beneficiaries of the August 1991 coup attempt; after this, Yeltsin and his group emerged with increased legitimacy and with almost no opposition. Shortly thereafter, the Yeltsin administration rejected an economic platform that favored an industrial policy and which was designed by an alternative group of his advisers along the lines of the "Asian economic model."¹⁸ Instead, Yeltsin made his choice in favour of an economic strategy put forward by radical reformers (the Burbulis-Gaidar group), whose Western inspiration was the Thatcher-Reagan revolution and who favored the almost complete dismantling of government economic controls.¹⁹ While at least twelve alternative programs for the reform of the Soviet economy were advanced by both Russian and Western economists between 1989 and 1991,²⁰ the final choice was made in the favour of radical "economic medicine" - that of shock therapy.

The discussion of the choices made by the Russian administration would not be complete without acknowledging the enormous challenges the reformers were facing. The task was no less than that of replacing the disintegrating state-controlled economy with a modern mixed economy. There was no relevant precedent, theory, or experience that could help in guiding the reformers through this uncharted territory²¹ - and yet they had to enter it. Another important factor that influenced the choice of reform strategy was the assumed political threat of a return to communism and to central planning in particular.²² The collapse of both the USSR and the Communist Party was seen as a

¹⁷ David Kotz and Fred Weir, Revolution From Above: The Demise of the Soviet System (New York: Routledge, 1997).

¹⁸ Jerry Hough, The Logic of Economic Reform in Russia (Washington, D.C.: Brookings Institution Press, 2001) 131.

¹⁹ Peter Reddaway and Dmitri Glinski, The Tragedy of Russia's Reforms: Market Bolshevism Against Democracy (Washington, D.C.: United States Institute of Peace Press, 2001) 269.

²⁰ Reddaway and Glinski 269.

²¹ Gail W. Lapidus, The New Russia: Troubled Transformation (Boulder: Westview Press, 1995) 39.

²² Peter Rutland, "The Rocky Road from Plan to Market", in Stephen White et al., eds., Developments in Russian Politics, 4th ed. (Durham: Duke University Press, 1997) 150.

unique window of opportunity to introduce radical economic reform.²³ Many reformers believed that there was no real alternative to a radical strategy of economic transformation. Thus, Aslund, who served as an economic advisor to the Russian government at the time, writes:

Under the circumstances prevailing in Russia in late 1991, it would have been lethal to hesitate or move slowly....the real implication of compromise would be to surrender power to the old antidemocratic establishment....the more radical the liberalization, the sooner markets will be cleansed of distortions and corruption.²⁴

While some observers²⁵ argued that the radical approach to economic reform was the only option in late 1991, and saw shock therapy as the only bridge from communism to capitalism, others²⁶ suggested that there were alternatives to radical reform strategy at that time, and that shock therapy was not the most feasible approach to the transitional challenge. Thus, according to Reddaway and Glinski,

...we interpret shock therapy...as a politically conservative counter-reform designed...to weaken the potential for the continuation of the democratic revolution....Before the beginning of shock therapy, Yeltsin and his associates possessed a number of alternative possibilities for leading Russian society out of its historical impasse. The effect of shock therapy has been to complicate or even to foreclose those alternatives.²⁷

On a theoretical level, the merits of radical economic reform and shock therapy as a strategy of economic transformation were extensively debated by two prominent specialists on Soviet and East European economics, Brada and Murrell;²⁸ the two contrasting perspectives were further assessed in detail by Hall and Elliot.²⁹

While the debate between the proponents and opponents of the shock therapy approach is an ongoing one, the analysis presented in this project is sympathetic to the

²³ Rutland 149.

²⁴ Aslund 10-11.

²⁵ See, for example, Aslund, Sachs, Brady.

²⁶ See, for example, Nolan, Stiglitz, Silverman and Yanowitch.

²⁷ Reddaway and Glinski 256, 308.

²⁸ Josef C. Brada, "The Transformation from Communism to Capitalism: How Far? How Fast?" *Post-Soviet Affairs* (1993/9/2): 87-110; Peter Murrell, "What is Shock Therapy? What Did it Do in Poland and Russia?" *Post-Soviet Affairs* (1993/9/2): 111-140.

²⁹ Thomas W. Hall and John E. Elliot, "Poland and Russia One Decade After Shock Therapy", *Journal of Economic Issues* (June 1999): 305-315.

perspective of those³⁰ advocating a gradualist, evolutionary approach with a social-democratic orientation. The following argument put forward by the opponents of radical economic reform seems to be a valid one: in the autumn of 1991, six years since the democratization process had been initiated by Gorbachev, and in a situation where both the USSR and the Communist Party of the Soviet Union had collapsed, the real choice for the Russian administration and the society as a whole was not about whether or not to move from socialism to capitalism - this choice had already been made - but rather about *how* to move to the market.³¹ It could be reasonably argued that in late 1991, while the policy choices were indeed considerably constrained by the scope of the challenges the reformers were facing, these choices nevertheless were not limited to radical economic strategy alone.

Despite the alternatives available, on October 28, 1991, a speech was made by Yeltsin where the main theme was his commitment to radical economic reform, represented by a strategy with the basic elements of stabilization, liberalization, and privatization, also known as the “Washington consensus” package.³² According to Reddaway and Glinski, “... [f]or the Russian parliament, unsophisticated in economics, the confident tone and the reassuring promises [of the speech] relieved some of their main worries,”³³ and on November 1, 1991, the parliament voted to grant Yeltsin additional powers to carry out the reforms. Two months later, Russia’s road to the market began with a vigorous “big bang,” better known as the “shock therapy” approach.

³⁰ See, for example, Cohen and Schwartz, Silverman and Yanowitch, Reddaway and Glinski, Job, and Bogomolov.

³¹ Reddaway and Glinski 243.

³² Braguinsky and Yavlinsky 106.

³³ Reddaway and Glinski 279.

2.2. Elements of economic reform: policies and their direct effects

At a meeting of the G-7 in Houston in 1990, participants requested that the IMF, the World Bank, and the Organization for Economic Co-operation and Development carry out a study of the Soviet economy and to outline recommendations for reforms. A number of Soviet economic and financial agencies also worked on the project. The report's proposed radical-liberal model of market reform had been rejected by Gorbachev's administration but later was adopted as a guide for the transformation of the Russian economy by Yeltsin's administration despite warnings about potentially dangerous consequences of the "shock therapy" approach.³⁴ The essence of the reform can be best described by referring to its three main components: macroeconomic stabilization; abolition of price controls and liberalization of domestic and foreign trade; and privatization.³⁵

Macroeconomic stabilization implied a package of measures aimed at the establishment of a stable, convertible currency combined with policies to control inflation. These measures and policies included tight monetary and credit policy, attracting international financing by utilizing foreign credit, making cuts in government spending, balancing the government budget, and re-organizing the financial system through reform of the tax and banking systems.³⁶

The second element of radical economic reform, liberalization, included abolition of price controls through the elimination of subsidies to consumer and producer goods, services, and labour.³⁷ While a few basic commodities were excluded from price liberalization, 90 percent of consumer prices and 80 percent of producer prices were freed

³⁴ Bogomolov 98.

³⁵ Braguinsky and Yavlinsky 106-108.

³⁶ Sakwa 235.

³⁷ Aslund 140.

immediately after the policy of price liberalization took effect on January 2, 1992.³⁸ The reformers were apparently convinced that a swift, comprehensive liberalization of prices was a necessary pre-condition for the success of the transition.³⁹ In addition to price liberalization, the second component of the economic reform package included liberalization of foreign trade through the lifting of export and import licenses and quantitative restrictions, lowering of tariffs, devaluation of domestic currency and making it convertible on the current account. All enterprises were given the freedom to engage in foreign trade.⁴⁰ Liberalization of foreign trade took effect along with the liberalization of domestic trade, which included the freedom to establish enterprises, to engage in trade and production, and to determine prices on goods and services offered to consumer.⁴¹

The final element of the radical economic reform was that of the privatization of the state-owned enterprises. The purpose of privatization was to transform enterprises into self-financing units, which could then be regulated by financial, fiscal and monetary means that would replace the administrative-command methods of control. It was assumed that the private sector of the economy in most cases would immediately become more efficient than the state-owned sector.⁴²

Small and medium-sized enterprises were privatized either through tender offers or auction; large enterprises initially were meant to be privatized through voucher schemes, though exceptions were made to this rule, including the "loans-for-shares" privatization scheme discussed later. Privatization was the key part of the radical structural reform package and it was carried out at high speed. According to Richard

³⁸ Aslund 139.

³⁹ Aslund 139.

⁴⁰ Aslund 145-149

⁴¹ Aslund 139.

⁴² David Lane, Russia in Transition: Politics, Privatization and Inequality (London and New York: Longman, 1995) 145-157.

Layard, advisor to the Russian government, the privatization program produced the “fastest rate of privatization in *human history*, in which in one month the Russian government is privatizing more than Mrs. Thatcher did in ten years.”⁴³ Already by the end of 1994, 70 percent of state property had been transferred to private hands and 70 percent of all workers were working in the private sector.⁴⁴

The above strategy, proposed within the framework of the radical structural reform package, could be briefly summarized as follows: cut government expenditures and eliminate the budget deficit, raise all prices to free-market levels, privatize most state enterprises, and economic growth will follow. Let us now consider some direct macroeconomic effects of the structural adjustment strategy adopted in Russia in 1991⁴⁵.

2.2.1. Macroeconomic stabilization

As we have seen, the policies of macroeconomic stabilization involved a budget deficit reduction and strict limitations on credit and money supply. The inflationary spiral had to be kept under control, the current account balance had to be improved, and the government deficit had to be eliminated. If growth was to be resumed, it was important at the time to mobilize domestic savings in order to be able to pursue development-oriented policies.⁴⁶

The macroeconomic stabilization program had some positive effects. Direct subsidies from the government to enterprises were abolished, and the government was largely able to keep its budget deficit and the money supply under control. Much more

⁴³ Richard Layard as cited in Nolan, 276; emphasis in original.

⁴⁴ Nolan 276.

⁴⁵ Although the focus of the following section primarily is on the immediate and medium-term macroeconomic effects, occasionally it will be necessary to refer to a longer timeframe of up to seven years.

⁴⁶ Luiz Carlos Pereira, Jose M. Maravall and Adam Przeworski, Economic Reforms in New Democracies: A Social-Democratic Approach. (Cambridge: Cambridge University Press, 1993) 8.

attention was now being paid by the managers of newly privatized enterprises to the costs and the quality of supplies, and to the marketing of products and services.⁴⁷ However, the adopted measures also produced a number of negative effects actually hindering the transition to a market economy in very important respects. Thus, the share of loss-making firms increased from about 7 percent in 1992 to almost 50 percent in 1997. With that, a large number of unprofitable enterprises have stopped paying both taxes and wages.⁴⁸ Another effect of the Yeltsin-IMF program was money becoming so scarce that more than half of the economic transactions had to be conducted through barter. According to Braguinsky and Yavlinsky's analysis, the share of non-monetary settlements rose from 6 percent in 1992 to 41 percent during the first half of 1997; another estimate suggests that share could have been as high as 70 percent by the end of 1997.⁴⁹ The main result of the above once again has been a sharp drop in tax revenue.

Macroeconomic stabilization has also failed in its anti-inflationary aspect. With the initiation of the policy of structural adjustment, the official rate of the rouble⁵⁰ to the dollar began to fall dramatically: if by the summer of 1991, the rate was approximately 25 roubles to the dollar, by December 1992 it had reached 400 roubles to the dollar and by October of 1994, it was 3,926 roubles to a dollar. It follows that anyone - and that includes the majority of country's population - who held their savings in roubles in 1991 had the value of their savings drastically reduced and often eliminated.⁵¹ The table below shows both the immediate and long-term outcomes in respect to the levels of inflation: while these levels were the most pronounced in 1992 and 1993, a rate of inflation was

⁴⁷ Braguinsky and Yavlinsky 109-110.

⁴⁸ Braguinsky and Yavlinsky 111.

⁴⁹ Braguinsky and Yavlinsky 112.

⁵⁰ A unit of Russian currency.

⁵¹ Bartłomiej Kaminski, ed. Economic Transition in Russia and the New States of Eurasia (London: M. E. Sharpe, 1996) 232.

standing at over 400 percent per annum on average during the first seven years of reform.

Table 1. Inflation, 1992 - 1998
(Average annual rate, per cent)

1992	1993	1994	1995	1996	1997	1998	Yearly average for 1992- 1998
1,354	896	220	190	48	11	84.5	400.5

Sources: adapted from Reddaway and Glinski, "The Tragedy of Russia's Reforms"(2001) p.249; OECD Publications, "The Social Crisis in Russian Federation" (2001) p.34.

Although Gaidar, one of the main ideologues of radical reform, predicted that stabilization would take place within a year from the moment of the initiation of shock therapy, it was not until 1999 that Russia finally achieved a limited degree of "macroeconomic stabilization."⁵²

2.2.2. Abolition of price controls and liberalization of trade

The abrupt removal of price controls, while indeed balancing short-term supply and demand and overcoming shortages of basic supplies, led to a significant increase in retail prices.⁵³ within a few days of lifting state controls over retail prices the latter rose by 300-500 per cent, which resulted in a drastic fall in real consumption.⁵⁴ Within a year, the price of bread, for example, increased by more than a hundred times, while real earnings declined by more than 80 percent.⁵⁵ According to Tikhomirov, the real average wage in the Russian national economy fell by almost two-thirds during the first five years of reform,⁵⁶ a factor contributing to a further decline in real living standards.

⁵² Reddaway and Glinski 248; macroeconomic stabilization as judged by GDP levels, inflation rates, and the volume of industrial output. Figures illustrating the degree of economic decline are shown in section 2.3.1.

⁵³ Vladimir Tikhomirov, *The Political Economy of Post-Soviet Russia* (New York: St. Martin's Press, 2000) 228.

⁵⁴ Oliver Blanchard et al, *Post-Communist Reform: Pain and Progress* (Cambridge: The MIT Press, 1993)19; Reddaway and Glinski 247.

⁵⁵ Michael Chossudovsky, *The Globalization of Poverty: Impacts of IMF and World Bank Reform* (London: Zed Books, 1997) 226.

⁵⁶ Tikhomirov 192.

The instant removal of state monopoly in the area of foreign trade opened ways for quick and virtually unlimited enrichment on the part of the Russian elite that had access to, or control over, export production and distribution.⁵⁷ On the other hand, the opening up of the economy was followed by the local manufacturing industry sliding into a deep recession: the abrupt freeing of foreign trade meant a massive supply shock to national manufacturing, further aggravated by the negative effects of collapse in demand from the former Soviet republics and the COMECON states, and in government demand.⁵⁸

Price liberalization carried out in the absence of an effective distribution system, commercial banks or a labour market, inevitably led to a prolonged economic slump; the lifting of price controls and subsidies should have been preceded by building institutions and demonopolization.⁵⁹

2.2.3. Privatization

The final element of the 1992 Yeltsin-IMF reform was the mass privatization of state property: privatization has been the core policy of economic liberalization in Russia. By the end of 1996, 90 percent of the gross output of both industry and the retail trade were coming from the private sector.⁶⁰ According to the reformers, privatization of state property should have led to the growth of efficiency in the economy as a whole, followed by an increase in gross output and accumulation of investment capital within the country. Yet the results were quite the opposite: national production output continued to decline, efficiency in most sectors of the economy remained low, and large amounts of currency

⁵⁷ Tikhomirov 229.

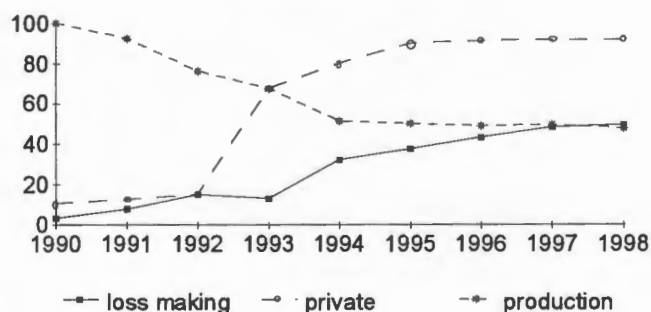
⁵⁸ Braginsky and Yavlinsky 115.

⁵⁹ Sakwa 253

⁶⁰ Tikhomirov 2.

were exported from Russia as opposed to being invested in the economy.⁶¹ The graph below shows that the mass sale of state property failed to achieve its main objective of reversing Russia's negative production dynamics: privatization has failed to generate any significant growth in the national economy.

Figure 1. Privatization vs. Performance in Russian Industry
(indices, %)



(**production** = Dynamics of industrial production (gross industrial output); **private** = Share of private sector in industry; **loss-making** = Share of loss-making enterprises in industry)

Source: Vladimir Tikhomirov, "The Political Economy of Post-Soviet Russia," p. 262.

The essence of the privatization campaign was bluntly expressed by Yeltsin's chief economic advisor and Deputy Prime-Minister Yegor Gaidar in the following way: "We allowed the elite to exchange their power for property."⁶² The fact that a small group of insiders from the old communist-era elite took control over vast resources was viewed as an injustice by those who believed in democracy and reform, and were supporting Yeltsin and his associates during the critical time of their assault on the old system. Gaidar's statement, in fact, turned out to be only a half-truth: while elites indeed were able to appropriate most of the state's property, in many cases at the same time they were allowed to retain power and their positions at the top levels of both the government and

⁶¹ Tikhomirov 259.

⁶² Yegor Gaidar as cited in Rose Brady, *Kapitalizm: Russia's Struggle To Free Its Economy* (London: Yale University Press, 1999) 63.

the enterprises. On the other hand, Gaidar's statement shows the populism of earlier Yeltsin declarations such as one in which Yeltsin told Russians that "... we need millions of owners rather than a handful of millionaires ... the privatization voucher is a ticket for each of us to a free economy."⁶³

While indeed millions of privatization vouchers were distributed to the public - one for every adult and a child - their value turned out to be worth less than \$25 each. Most people either sold them immediately due to their hyperinflation-caused impoverishment, or else 'invested' them in fraudulent voucher pyramids posing as legitimate mutual funds. In the end, the shares purchased with vouchers mostly ended up in the hands of the same *nomenclatura*⁶⁴ who benefited from other forms of privatization.⁶⁵ In addition, the value of state property was kept artificially low; therefore, state assets could be - and were - acquired at a fraction of their market value.⁶⁶ Thus, as an example, a downtown Moscow hotel could have been purchased for less than the price of a Paris apartment; an enterprise identical to a Polish company that sold earlier for \$80 million during the course of Polish privatization, sold in Russia for slightly more than half a million.⁶⁷

"Voucher privatization" should be differentiated from what became known as the "loans-for-shares" privatization scheme, under which certain banks were allowed to acquire control of some of Russia's largest oil and natural-resource companies for low prices. Sachs called the "loans-for-shares" scheme one of the most corrupt privatization processes in world history: "tens of billions of dollars worth of natural resource deposits

⁶³ Yeltsin as cited in Reddaway and Glinski, 248.

⁶⁴ This term describes the Soviet (and later the Russian, Ukrainian, Kazakh, etc.) party-state elite. As the political developments of post-Soviet Russia and the other FSU states have shown, *nomenclatura* turned out to be neutral to ideology - and thus it could be communist, anticommunist, and even "democratic", depending on the circumstances.

⁶⁵ Brady 65-118.

⁶⁶ Menshikov 138; Chossudovsky 231.

⁶⁷ Brady 75.

were turned over to Yeltsin's insiders, doing much to create the corrupt 'oligarchy' that has so poisoned Russia's politics..."⁶⁸ Most privatizations were carried out through backroom deals among insiders, with company managers and the *nomenklatura* the most frequent beneficiaries. In contrast to the Western practice of privatization, which started with loss-making enterprises, in Russia it was the most profitable enterprises (including strategic asset industries) that were first of all given up into private hands. As a result of such a policy, the state treasury has been emptied and the state itself became almost bankrupt.⁶⁹ During the privatization campaign, "the 'property of all the people' was turned into a boundless reservoir of funds for personal enrichment;"⁷⁰ it is no surprise that most observers use negatively-charged terms while describing the event: "nomenklatura privatization," "predatory privatization," "phony privatization," and "robber baron privatization."⁷¹ Ill-designed, marked by corruption, failing to deliver results in terms of increased efficiency, and adding another serious institutional lock-in to the extremely difficult task of restoring Russian industry, "...the Russian privatization program [has been one of] the most spectacular failures in the history of economic reform."⁷²

There are several lessons that can be learnt from the experience of the Russian privatization attempt. First, privatizing ownership will not necessary make uncompetitive enterprises operate more efficiency. Secondly, companies do not exist in an institutional vacuum: socioeconomic institutions are needed as a precondition for private ownership. Finally, dishonest and ineffective public administration and the related problem of corruption represent a major threat to both economy and democracy.⁷³

⁶⁸ Jeffery Sachs, "Russia's Tumultuous Decade," Washington Monthly Vol. 32, Issue 3, (March 2000):37.

⁶⁹ Bogomolov 102.

⁷⁰ Boris Kagarlistky, Restoration in Russia: Why Capitalism Failed (London: Verso, 1995) 3.

⁷¹ Terms used by Reddaway and Glinski; Derlugian; Braguinsky and Yavlinsky; and Stiglitz respectively.

⁷² Braguinsky and Yavlinsky, 122-123.

⁷³ Stephen Cohen and Andrew Schwartz, "Deeper Into the Tunnel," The Tunnel at the End of the Light: Privatization.

There were claims made by some observers that the policies of structural adjustment/shock therapy were gradually phased out in the second half of 1992; another viewpoint is that they had never been applied in Russia in its original design in the first place.⁷⁴ However, the important thing to note here is that the fiscal and monetary prescriptions of shock therapy were generally adhered to by the Russian administration during the timeframe between 1992 and 1999. Thus, as Gill and Markwick point out, in the course of most of the 1990s,

[p]rices remained unregulated, state orders were reduced, government spending continued to be reduced, industrial subsidies declined, the rouble was made convertible, the economy was opened up to foreign investment, most controls on exports and imports were eased ... the second ingredient of shock therapy, wholesale privatization of state enterprises, was implemented.⁷⁵

While the Yeltsin administration made numerous retreats and tactical maneuvers over the course of two presidential terms, the doctrine of shock therapy within the framework of a radical economic reform guided the policies of Yeltsin and his associates for most of the 1990s; as Reddaway and Glinski show, the appointment in March 1997 of radical reformers Chubais and Nemtsov was seen by most Western and Russian observers as "the second round of shock therapy offensive."⁷⁶ Therefore, claims stating that the policies of shock therapy were applied in Russia only during a relatively short period of 1992-1993 cannot be supported by the available evidence.

To sum up the discussion about the elements of economic reform in Russia: the neoliberal economic strategy with the basic elements of stabilization, liberalization and privatization has had some positive effects on only a marginal part of the Russian

Business Networks, and Economic Transformation in Russia," ed. Stephen Cohen et al. (Berkeley: University of California, 1998) 8.

⁷⁴ See, for example, Aslund; Sachs.

⁷⁵ Graeme Gill and Roger Markwick, Russia's Stillborn Democracy? From Gorbachev to Yeltsin (New York: Oxford University Press, 2000) 139.

⁷⁶ Reddaway and Glinski 234, 532-541.

economy.⁷⁷ The real economic indicators otherwise testify to a large-scale collapse of the nation's economy. Privatization, the core policy of economic liberalization, failed in its objective of increasing the country's economic output and ultimately raising the population's living standards.

As we have seen, the immediate and medium-term macroeconomic effects of the structural adjustment policies have had, for the most part, a negative influence on the national economy. At the same time, a short transitional recession has been both predicted and anticipated by the proponents of the radical approach to the transition. Let us now conclude the discussion of the direct effects of the adopted economic strategy and move on to consider the more general and long-term economic, social, and political outcomes that are the subject of the next section.

2.3. Long-term outcomes

The pitiful condition in which today's Russia finds itself has become well known through both the mass media and academic writings; it would be reasonable to assume this condition is evident to most observers and is beyond dispute. Considering the space limitations of this project, we will touch on a few topics that represent the major long-term economic and social outcomes of the post-Soviet reform.

2.3.1. Economic outcomes

The economic crisis experienced by Russia in the post-Soviet period has indeed been a profound one. According to Reddaway and Glinski, the level of decline "...has exceeded that of the comparable American experience during the Great Depression and the

⁷⁷ This progress mostly relating to foreign trade and consumer demand (Braguinsky and Yavlisky 116).

industrial loss inflicted on the Soviet Union in 1941-45 by World War II.”⁷⁸ Let us look at the most important indicators first. From 1991 to 1998, the national GDP declined by 43.3 percent; industrial production fell by 56 percent and the agricultural output declined by almost 60 percent.⁷⁹ Capital investment in the Russian economy during the first four years of reform fell by 78 percent and that trend has continued ever since.⁸⁰ At the same time, large amounts of capital are being transferred abroad: the issue of capital flight became a serious problem in a country where an estimated US\$12-15 billion is leaving the country on an annual basis.⁸¹ The estimates of the gross capital flight since 1990 range anywhere from US\$150 billion to US\$400 billion during the first seven years of liberal economic reform.⁸²

It appears that one of the most helpful and illustrative ways to show the dynamics of post-communist Russian development is to present essential indicators⁸³ in a tabulated form. The following two tables show selected indicators for the years 1993-1999; both illustrate the magnitude of the Russian economic recession.

Table 2. General Indicators of Russia's Performance in 1993-97.

	1993	1995	1997
<i>Gross Domestic Product</i>			
Dynamics of GDP, 1993=100 ^a	100.00	83.9	79.2
Annual change, %	-12.0	-4.0	0.4
<i>Federal Budget</i>			
Revenues, 1993=100 ^{ab}	100.0	108.30	90.2
Expenditure, 1993=100 ^a	100.0	65.6	57.0
Budget deficit, 1993=100 ^a	100.0	23.1	24.0
<i>State Borrowing</i>			
Foreign debt in US\$, 1993=100 ^c	100.0	129.7	136.6

⁷⁸ Reddaway and Glinski 2.

⁷⁹ Reddaway and Glinski 2.

⁸⁰ Reddaway and Glinski 2.

⁸¹ Tikhomirov 148.

⁸² Tikhomirov 148.

⁸³ Table 3 includes economic indicators as well as selected social indicators; the latter refer to section 2.3.2.

<i>Overdue Social Payments</i>			
Gross wage arrears, 1993=100 ^{ac}	100.0	143.4	330.1
Unpaid wages as % of gross monthly wage fund in all national economy	7.7	27.1	66.7
<i>Performance of the Economy</i>			
Industrial output, 1993=100	100.0	76.1	73.3
Agricultural output, 1993=100	100.0	80.9	75.3
Gross volume of unpaid taxes, 1993=100 ^{ac}	100.0	94.7	162.7
Inter-enterprise debt, 1993=100 ^{ac}	100.0	33.6	61.7
Dynamics of capital flight, 1993=100	100.0	141.2	152.7
<i>Social Dynamics</i>			
Average income:			
In US dollars, 1993=100	100.0	202.0	289.7
In constant prices, 1993=100 ^a	100.0	97.9	101.3
Unemployment, 1993=100 ^{cd}	100.0	154.6	153.8

Notes:

^a In constant prices. Calculated using GDP deflations.

^b Russian Statistics on revenues of the federal budget include internal and foreign loans

^c As at the end of the year.

^d ILO methodology.

Source: Vladimir Tikhomirov, "The Political Economy of the Post-Soviet Russia" (2000), p. 325, 326.

Table 3. Selected economic and social indicators, 1994-1999

	1994	1995	1996	1997	1998	1999
Real GDP index (per cent change)	-12.7	-4.2	-3.5	0.9	-4.9	3.2
Real industrial output index (per cent change)	-21.0	-3.0	-4.0	2.0	-5.2	8.1
Consumer price inflation (per cent)	215.1	131.3	21.8	11.0	84.5	36.5
Real per capita income (1993 = 100)	111.9	83.9	99.6	102.8	83.1	84.9
Unemployment rate (ILO definition, per cent)	7.4	8.8	9.9	11.2	11.7	12.6
Share of loss-making enterprises (per cent)	32.5	34.2	50.6	50.1	49.2	48.7
Mortality rate (per 1,000; 1990 = 11.2)	15.7	15.0	14.2	13.8	13.6	14.7
Population (million)	147.9	147.6	147.1	146.7	146.0	145.6
Total social spending (per cent of GDP)	17.9	15.1	16.2	17.3	16.4	12.6

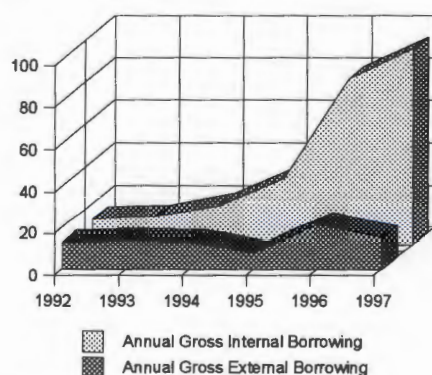
Sources: OECD Publications, "The Social Crisis in the Russian Federation" (2001) p. 34, 37; Jeni Klugman, "Poverty in Russia: Public Policy and Private Responses" (1997) p. 93.

The radical economic reform of 1992 eliminated the old structures of regulation, finance, and law, but failed to build an adequate system of domestic institutional infrastructure, including institutions of financial regulation, a system of proper taxation, a policy in

support of competition, an appropriate legal framework, and measures to stimulate the transfer of technologies and to enhance market transparency.⁸⁴ On the threshold of the new century, the productivity of the Russian economy “was cut to less than half, industrial output fell to 40 percent of what it had been, and in the light industry and the food industry it dropped by two-thirds,”⁸⁵ as compared with the pre-reform level.

Since the beginning of the transition, the Russian economy has not experienced any meaningful growth. Neither has the Russian government succeeded in accumulating foreign currency reserves on any significant scale.⁸⁶ While most of the investment in industry was directed towards the oil and gas sectors, no new notable production plants were built during the years of reform; the Russian economy does not have internal economic mechanisms for growth.⁸⁷ Within a period of seven years the country’s external debt has grown 3.7 times from about US\$40 billion at the beginning of the reform in 1992 to about US\$147 billion in early 1999.⁸⁸ The figure below illustrates the dynamics of state debt accumulation.

Figure 2. Annual Dynamics of Growth of State Debt Accumulation (billion current US dollars; annual gross borrowing only, not net debt)



Source: Vladimir Tikhomirov, “The Political Economy of the Post-Soviet Russia” (2000), p. 61.

The financial crisis of August 1998 and the Russian government’s default on its loan

⁸⁴ Stiglitz, “Whither Reform” 24.

⁸⁵ Bogomolov 99-100. The figures cited by Bogomolov differ slightly from those cited by Reddaway and Glinski at the beginning of section 2.3.1.

⁸⁶ Braguinsky and Yavlinsky 116.

⁸⁷ Menshikov 92.

⁸⁸ Vladimir Tikhomirov, “The Second Collapse of the Soviet economy: Myths and Realities of the Russian Reform.” *Europe-Asia Studies* Vol 52 Issue 2 (March 2000): 207.

repayment obligations has further underscored the fragile and unstable nature of the Russian transition to the market economy.

Thus, as Braguinsky and Yavlinsky note, “the ‘achievements’ of the policy of macroeconomic stabilization are ... completely illusory.”⁸⁹ It can be argued that one of the major causes of the reform failure has been too much emphasis on macroeconomic stabilization at the expense of institution-building.⁹⁰ Creating a purely liberal economy in Russia over a short period of time, in conditions where an appropriate institutional infrastructure has been almost nonexistent turned out to be a utopian idea.

It must be noted that over the last two years⁹¹, the Russian economy has finally achieved, for the first time since 1991, stabilization of its economy and even a modest degree of economic growth.⁹² The two major factors of this recovery were high global oil prices and a fivefold depreciation of the national currency. High oil prices created a surplus in the budget while the devaluation stimulated national production and exports. Despite this growth, the Russian government itself on many occasions has admitted that these favorable factors cannot be counted on in the medium and long term.⁹³ The economy remains highly vulnerable to commodity price swings. Resource extraction revenue alone cannot support the Russian economy for any prolonged period of time.⁹⁴ Unless the national economic growth of the last two years is secured by sustainable economic policy, the Russian administration “... will confront an impoverished population and a crumbling Soviet infrastructure with no tools at hand.”⁹⁵

In summing up the discussion regarding the outcomes of Russian economic

⁸⁹ Braguinsky and Yavlinsky 116.

⁹⁰ “Sick Patients, Warring Doctors” *Economist* 18 September 1999: 81.

⁹¹ 1999-2000.

⁹² Deluguian 26.

⁹³ Lukin 48.

⁹⁴ Braguinsky and Yavlinsky 242.

⁹⁵ Lukin 48.

reform, it is difficult not to agree with Tikhomirov's conclusion when he states that "...by the end of 1998 Russia was even farther away from achieving its initial reform objectives, than it was at the very start of reform in 1992."⁹⁶

2.3.2. Social outcomes

a) Decline in the quality of health care and education

The eroding safety net resulted in the rapid deterioration of the health care and educational systems. There was transfer of responsibility for these spheres from the central to the local and provincial governments. Since such a transfer was not accompanied by an adequate transfer of funds, the quality of health care and education has been reduced.⁹⁷ Doctors and teachers are presently among the lowest income-earning group; both hospitals and schools were forced to introduce user fees for a number of essential services, making such services inaccessible to the poorer segment of the population. There was a large increase in mortality rates coupled with a decrease in life expectancy that coincided with the attempts to introduce market reforms. Studies have shown that mortality in Russia is strongly correlated with such measures of reform success - or its failure - as GDP growth, inflation, and unemployment rates.⁹⁸

b) Social costs of unemployment

It came as no surprise that reductions in state subsidies and the privatization of state property made unemployment unavoidable. However, the magnitude of unemployment has been larger than predicted. According to Nolan, already in 1994 the number of unemployed was estimated at 10 million, representing 13 percent of the economically

⁹⁶ Tikhomirov 332.

⁹⁷ Silverman and Yanowich 25.

⁹⁸ Elizabeth Brainerd, "Market Reform and Mortality in Transition Economies," World Development (1998, Vol. 26, No. 11) 2013.

active population. At the same time, a large proportion of the employed were receiving no pay for long periods of time.⁹⁹ According to Tikhomirov, total employment declined from a figure of over 75 million people in 1990 to 64.6 million in 1997, representing a negative change of 14 percent over the time period of 1990-1997.¹⁰⁰ The unemployment indicators from yet another source show a pattern where unemployment is slowly but steadily increasing from 1 percent in 1992 to the high of 13.3 percent in 1998, only slightly diminishing to 12.0 percent in 1999, based on official estimates.¹⁰¹ Determining the real levels of unemployment is difficult since the registered unemployment figures do not include a substantial number of unemployed who fail to register.¹⁰² Clarke cites an example of one of the Russia's regions where the official unemployment rate was standing at 2 percent, while the independent labor force survey came to a conclusion that the unemployment rate at the time stood at 23 percent.¹⁰³ Thus, another outcome of liberal economic reform has been that of a previously unknown phenomenon, mass unemployment.¹⁰⁴

c) Poverty and inequality

Unemployment resulted in falling incomes, which in turn were followed by an increase in levels of poverty for the majority of the population. The reforms "created a handful of super wealthy individuals, while leaving the rest behind to struggle."¹⁰⁵ According to different estimates of poverty shown in Table 4 below, poverty levels were within the range of 30-50 percent on average in 1993-94 and remained almost unchanged five years

⁹⁹ Nolan 22.

¹⁰⁰ Tikhomirov 170.

¹⁰¹ "Key Data 1990-99", <http://www.bcemag.com/_bcedb/history.idc>

¹⁰² The collapse in real government expenditure led to falling levels of government unemployment pay; as a result, fewer and fewer unemployed were bothering to register.

¹⁰³ Clarke, "Poverty in Russia" 12.

¹⁰⁴ Bogomolov 100.

¹⁰⁵ Braguinsky and Yavlinsky 7.

later, standing on average at around 40 percent in 1999. It follows that in absolute numbers, over 58 million people in the Russian Federation were living below the poverty line by the end of 1999.¹⁰⁶

Table 4. Estimates of Russian Poverty Rates

Source	Period	Estimated proportion of impoverished population (%)
Yogesh Atal	1960-1985	10
Official Estimates: Ministry of Labour	1991 1992 1993 1994 1999	55 36 29 25 38
Non-official Estimates:		
International Labour Organization (ILO)	1992	85
All-Russian Standard of Living Centre	1994	39
" <i>Arugmenty i facty</i> " newspaper	1994	61
Russian Centre for Public Opinion Research (VtsIOM)	1994	54
Tat'iana Saslavskaja	1993	40.7
Reddaway and Glinski	1999	41.2

Sources: Atal, "Poverty in Transition and Transition in Poverty," (1999) p. 31; Silverman and Yanowitch, "New Rich, New Poor, New Russia" (2000) p. 42, 47, 48; Reddaway and Glinski, "The Tragedy of Russia's Reforms" (2001) p. 620; OECD Publications, "The Social Crisis in the Russian Federation" (2001) p. 39.

At the same time, the household savings have been steadily diminishing over the period of 1991-1994:

Table 5. Changes in Savings Concentration
(Survey question: "Does your household have any savings?")

Answers	August 1991	March 1992	June 1993	October 1993	February 1994
Yes	66	60	25	19	17
No	30	36	71	76	78
Difficult to answer	4	4	4	5	5

Source: Atal, "Poverty in Transition and Transition in Poverty," (1999) p. 208.

Rising inequality has been yet another feature of Russian post-Soviet

developments. The measures of income distribution below indicate how rapidly the country has been transformed from a relatively equal society to one with considerable

¹⁰⁶ The subsistence minimum, based on the concept of absolute poverty, is used as the official poverty line in the Russian Federation. It is determined by the cost of a market basket, valued at average prices in each region, that provides the minimum required caloric intake.

income disparities. The Gini coefficient, a general measure of inequality, rose from 0.24 in 1989 to 0.48 in 1996, a doubling of inequality¹⁰⁷. According to Shlapentokh, the Yeltsin regime demonstrated very little concern for the plight of the poor, viewing social inequality as a “prerequisite” for economic growth:

...the liberal establishment of the 1990's virtually discarded such words as “equality” and “parity” from its lexicon. These words were almost completely absent from the speeches made by Yeltsin and his premiers in 1992-98, nor were they present in the multitude of articles and essays which lauded the regime during this period.¹⁰⁸

The income ratio between the wealthiest and the bottom 10 percent of population increased from 4:1 in 1990 to 15:1 in 1994, and in terms of the disparity in personal income, Russia is now ranked among countries such as Brazil, Venezuela and Mexico. As it stands today, all Western countries including the United States are much more egalitarian than Russia.¹⁰⁹ According to a recent study conducted by the World Bank, the level of social and income differentiation in Russia is estimated as the highest in Eastern Europe, and most participants of the study claimed that “the well-being of the absolute majority of the people had deteriorated during the last decade.”¹¹⁰

2.3.3. Political outcomes

Democratization of Russian society - as represented by a relatively free press, mass political parties, freedom of speech, and mostly free elections - appears to be the only major achievement the post-communist period can be credited with. However, that credit should be given mainly to Gorbachev's administration rather than that of Yeltsin's, as all the above democratic freedoms came during the period of 1987-1991¹¹¹. Furthermore,

¹⁰⁷ UNDP, *Human Development Report 1999* (New York: Oxford University Press, 1999) 85.

¹⁰⁸ Vladimir Shlapentokh, “Social Inequality in Post-Communist Russia,” *Europe-Asia Studies*. (November, 99): 1167.

¹⁰⁹ Shlapentokh 1155.

¹¹⁰ “Consultations with the Poor,” The World Bank, <http://worldbank.org/poverty/conspeer/national.htm>.

¹¹¹ This despite the fact Gorbachev has never been elected by the populace in contrast to Yeltsin.

many observers point out an inclination toward authoritarianism by both the Yeltsin and Putin administrations.¹¹² The Yeltsin regime's attempts to retain and consolidate its power without addressing the legitimacy issue resulted in a pattern of escalating autocratic centralization of executive powers. Traditions of totalitarianism and Bolshevism that Yeltsin and his aides inherited from their Soviet incarnation led to Yeltsin severely restricting the democracy created by Gorbachev.¹¹³ Thus, the Russian constitution was fraudulently amended in 1993 to increase presidential powers.¹¹⁴

Perhaps the most profound violation of the constitutional law occurred in October of 1993, when Yeltsin dispersed a democratically elected parliament by way of attacking the Russian White House with heavy artillery and special commando units, ending the Russian experiment in the democratic separation of powers and killing in the process close to two hundred members of parliament and their defenders.¹¹⁵ Yet another spectacular violation of democracy and the law took place during the 1996 presidential elections, when the expenses of Yeltsin's campaign ran at least thirty times above the legal spending limit and an additional \$10 billion in the Russian Treasury funds were spent with the aim of securing wider electoral support. There also were serious violations of the law in television and press coverage of the election campaign, coverage that was strongly tilted in favour of Yeltsin.¹¹⁶ In sum, "the logic of the political struggle led Yeltsin to eliminate or significantly curtail the powers of the independent institutions that had emerged during the Gorbachev period,"¹¹⁷ destroying the parliamentary republic and

¹¹² See, for example, Hough, Job, Kagarlistky, Fish, Deluguian, Buzgalin and Koganov, and Reddaway and Glinski.

¹¹³ Hough 129.

¹¹⁴ Job 933.

¹¹⁵ Alexander Buzhalin and Andrei Kolganov, Bloody October in Moscow: Political Repression in the Name of Reform. (New York: Monthly Review Press, 1994) 188,189.

¹¹⁶ Reddaway and Glinsky 515.

¹¹⁷ Aleksander Lukin, "Putin's Regime: Restoration or Revolution?" Problems of Post-Communism (Jul/Aug 2001, Vol. 48, Issue 4):38.

introducing super-presidential rule.

It can also be argued that a high-speed transition in itself is undemocratic: the faster the transition process, the less possibility there is for the population to provide feedback or to participate in that process. Thus, in Russia the population has been largely excluded from providing comments or suggestions in regard to reform outcomes due to the speed of the transition.¹¹⁸

Just a few years after adopting the neo-liberal developmental strategy, Russia ceased to have an independent economic policy and sunk to the level of a heavily indebted third world country, forced to comply with conditions imposed by the international financial institutions.¹¹⁹ "Russia became ever weaker internationally, to the point that its policies were constructed at the direct instruction of the major international capitalist institutions. In the brief space of just a few years it had been humiliated and broken as a great power."¹²⁰

Late 1999 and early 2000 saw Yeltsin successfully transferring his power to a chosen successor, Vladimir Putin. While it is too early to say which way Putin's presidency will affect democratic development, certain actions of the new Russian president give reason for concern: in his first decree, Putin granted his patron Yeltsin immunity from prosecution; he also has further concentrated political and economic power in his hands.¹²¹

As we can see from some of the accounts and observations discussed above, the fate of Russian democratization at the moment lies in the balance. While the future of democracy in Russia is uncertain, it is important to note that under Yeltsin, "Russia was

¹¹⁸ Nolan 87.

¹¹⁹ Nolan 286.

¹²⁰ Nolan 302.

¹²¹ Lukin 48.

thrown backward regarding the development of civil society and is now farther removed from the initial goals of the democratic movement than it was before Yeltsin came to power.”¹²²

3. Why the failure?

The roots of the reform failure are interconnected ones and can be ultimately traced to wrong policy choices. Economic and ideological radicalism, a wrong choice of developmental strategy, attempts to impose reform through a top-down approach while alienating the majority of population to the reform process through implementation of policies that have widened the gap between elites and society - these are the principal factors explaining the reform outcomes. Let us examine each one in turn.

3.1. Radicalism

It is highly symbolic that both Russian revolutions of the 20th century - that of 1917 and of 1991 - came under the sign of radicalism, both ideological and economic. Both the original socialist Bolsheviks and their new “market” incarnation viewed themselves as an enlightened vanguard who needed to implement their program from the top down; in the process, pain and sacrifice were a necessary part of building a brighter future. Neither group believed in alternative strategies to achieve its goals nor in a gradual approach to transforming the economy.¹²³ Both groups were able to ultimately seize power and to implement their top-down policies nation-wide. No wonder that the outcome has been

¹²² Reddaway and Glinski 628.

¹²³ Silverman and Yanowich xx (introduction).

similar, too: from the political oppression, economic inefficiency and ideological dogmatism of communism, the country moved to political instability, economic collapse, and poverty and inequality of the 1990s' unfettered capitalism. The neo-liberal economic radicalism of the last ten years, combined with the economic radicalism of the seventy years of the communist regime, resulted in a situation where the country found itself in a state of deep economic, social, and ideological crisis by the end of the 20th century.

In order to better understand the radical approach to economic reform and the roots of its failure in Russia, it is instructive to examine the viewpoint of shock therapy's most prominent advocates and the advisors to the Russian government in 1991-1992, David Lipton and Jeffery Sachs. Their discussion of the transition emphasizes the political success of the reform, at the same time ignoring, for the most part, the immediate economic effects. The focus has been on replacing existing institutional structures, as opposed to changing them. As Murrell writes, "[h]istory, society, and the economics of present institutions [were] all minor issues in choosing a reform program."¹²⁴ In the analysis of Lipton and Sachs circa 1992, "enormous scope exists for increases in average living standards... the issues of greatest importance can be solved within half a year."¹²⁵ While the establishment of a market economy, as envisioned by Lipton and Sachs, included the destruction of existing institutions, it was assumed at the same time that institutional construction can be achieved through technocratic solutions that are easy to implement. Thus, shock therapy in the view of its advocates "is nothing less than a revolutionary strategy for the complete reconstruction of the economic arrangements of a country,"¹²⁶ a strategy to be carried out within a relatively short period

¹²⁴ Peter Murrell, "What is Shock Therapy? What Did it Do in Poland and Russia?" *Post-Soviet Affairs* Vol. 9 Issue 2 (1993): 113-115.

¹²⁵ Lipton and Sachs as cited in Murrell, 114.

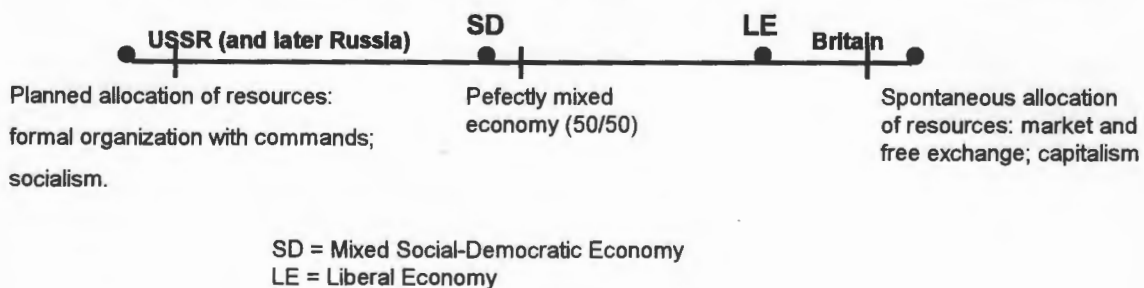
¹²⁶ Murrell 115.

of time utilizing a top-down policy approach.

3.2. *A wrong choice of developmental strategy*

Judging by the economic indicators of the late Soviet state, it becomes evident that the inefficient state-controlled planned economy of pre-reform USSR had to be dismantled and replaced with a modern mixed economy. An important question here is: what developmental model would have been the most suitable and beneficial? More specifically, what balance between decentralized decision-making and government control would have been the most appropriate for transitional Russia? Figure 3 shows a straight line representing the continuum of all existing and known economic systems with Britain of the first half of the 1800s (unfettered capitalism) at one end and the USSR with its almost pure command system at the other end. It is evident that a transition to a social-democratic economic model could have been an easier option for Russia: such a movement would have covered a much shorter distance on the continuum. The distance between "USSR" and "LE" represents a more difficult transition than from "USSR" to "SD", since an all-embracing change of the country's economic and institutional structures was required for a transition to a liberal model of economic management. In other words, many institutions of social democracy were already in place; there was no need to dismantle them.¹²⁷

Figure 3. The continuum representing different mixed-economy arrangements.



¹²⁷ Silverman and Yanowitch 129.

However, while the institutions of the old system had been largely destroyed in 1990 - 1992, it was assumed that the new market institutions are of secondary importance and would arise by themselves. This contradicts the growing evidence to the contrary in general, and the argument of the Nobel Prize laureate Douglass North in particular, who writes that

[i]nstitutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (rules, laws, constitutions), informal constraints (norms of behaviour, conventions) The single most important point about institutional change ... is that [it] is overwhelmingly incremental.¹²⁸

As we can see, markets are not self-forming mechanisms, but a set of institutions that are created on a gradual basis. In the Russian case, the existing institutions could have been adapted to the market economy framework in the way it has been done in China, where a gradual approach to reform was chosen and where existing institutions were modified to fit the new market realities.

concl.

One of the most comprehensive comparative Russia-China studies has been carried out by Peter Nolan,¹²⁹ in which he analyzed and compared reform policies and transition strategies in both countries. According to Nolan, prior to transition both countries shared many areas of fundamental similarity. On the other hand, looking at the differences between the systems, Nolan suggests that overall, the USSR was in a much more favorable position prior to the initiation of the reforms and thus was likely to perform better than China, not the reverse.¹³⁰ The key to understanding China's success and Russia's failure lies in the respective country's approach towards the transition strategy: in Russia, the leadership rapidly introduced most of the measures under the

¹²⁸ Douglass C. North, "Epilogue: Economic Performance through Time," in Lee Alston, Thrainn Eggertsson, and Douglass C. North, eds., Empirical Studies in Institutional Change (Cambridge: Cambridge University Press, 1996) 344.

¹²⁹ Nolan 1-320.

¹³⁰ Nolan 307.

“stabilization and structural adjustment package;” in China, on the other hand, an incremental, gradualist system of reform was chosen:

... the selection of different policies in Russia could have produced rapid growth of output and a large improvement in popular living standards, ...[while] the selection of a different set of policies in China could easily have produced a political and economic disaster, with a large decline in popular living standards....[T]he contrasting outcomes in China and Russia stem from the sharply different approaches taken by the respective leadership in the two countries towards the transition orthodoxy.¹³¹

Despite the fact that the economics of the Chinese reform were often considered in the West as primitive and were widely criticized, the Chinese leadership resisted those pressures and adopted policies what were quite contrary to those of the neo-liberal orthodoxy.¹³² The gradualist, incremental approach to reform resulted in a spectacular economic boom that continued almost uninterrupted into the 21st century. The growth of output and real income translated into substantial improvements in the physical quality of life for the majority of the country's population.¹³³ In the Russian case, “... the fundamental cause of the [Russian] collapse lies in the destruction of the state administrative apparatus and the nation-state....the reforms caused a disastrous decline in investment and industrial output, setting in motion a vicious circle of economic collapse.”¹³⁴

China's reforms show that a gradual process of institution creation¹³⁵ is both possible and viable, by pragmatically combining elements of the old and the new; and that sustained economic growth is possible without mass privatization of the state sector.¹³⁶ Over the ten-year period 1989-1998, Russia's GDP almost halved while China's GDP nearly doubled. At the same time, inequality in Russia doubled.¹³⁷ The

¹³¹ Nolan 302, 305.

¹³² Nolan 306

¹³³ Nolan 303.

¹³⁴ Nolan 309, 302.

¹³⁵ Institutions as represented by structures of law, finance, and regulation.

¹³⁶ Murrell 121.

¹³⁷ Joseph Stiglitz, “Whither Reform? Ten Years of the Transition,” World Bank Keynote Address (April 28, 1099) 3.

enormous success of China can be reasonably explained by that country's reliance on its own path of transition in contrast to the Russian approach, where a "blueprint," "one-size-fits-all" method had been applied. China's development path can be credited not only with rapid economic growth, but also with creating a vibrant non-state-owned collective enterprise sector, and with stimulating large-scale foreign investment in infrastructure, particularly in manufacturing. In contrast, there has been little productive investment in the post-1991 Russian physical infrastructure.¹³⁸ An argument stating that China's experience should be regarded as purely specific and unique and, therefore, should be looked upon as an exception is hardly convincing since the twenty years of sustained economic advance cannot be attributed exclusively to some kind of especially favorable circumstances specific to that country.¹³⁹

As Stiglitz argues, the institutional infrastructure, including both regulatory and legal structures, is absolutely essential to a functioning market economy.¹⁴⁰ According to Pereira et al., "[m]arket orientation is not sufficient to generate *market coordination* toward collective prosperity."¹⁴¹ Moreover, the reform approach must be highly dependent on the history and the specific nature of a given country.¹⁴²

3.3. Lack of mass support

This paper has been arguing that an alternative, moderate economic strategy with a social-democratic orientation would have been far less costly and would have offered better prospects for the Russian economy. For the purposes of this essay we will define

¹³⁸ Hough 14-15, Gustafson 221-222.

¹³⁹ Bogomolov 100.

¹⁴⁰ Stiglitz, "The Insider," 58

¹⁴¹ Pereira et al., 6; emphasis in original.

¹⁴² Murrell 125.

social democracy as an economic system operating within a framework of a mixed capitalist economy with a public sector accountable to the government, the national economy amenable to fine-tuning of demand, the vitality of democracy sustained by political pluralism and mass parties. This version of a social democratic project could be viewed as the principal democratic alternative to liberalism, a strategy ensuring that capitalism works for the maximum benefit of all.

Why social democracy? Apart from the institutional infrastructure aspect discussed above¹⁴³, a social-democratic approach to reform would cushion the transitional shocks experienced by the majority of the population and therefore would have the potential to ensure continuous mass support for reform. This aspect is of critical importance. Reform has failed, at least in part, because the Russian liberal reformers failed to understand that mass support is crucial for the outcome of the reform process. The implemented policies impoverished the majority of the population while increasing the gap between elites and the rest of society.

The great majority of Russian society was completely unprepared for the encounter with the market system and as a result ended up in financial ruin, becoming “the losing majority on the Russian expressway to capitalism.”¹⁴⁴ Thus, popular support for the market economy, which had been widespread in the country prior to the initiation of the radical reform program, has greatly diminished: the social costs of reform to Russian society have turned out to be exceptionally high.¹⁴⁵ It can be argued that mass support is central to both the achievement of a democratic outcome¹⁴⁶ and to a success of the economic dimension of reform. In the absence of such support, social tensions

¹⁴³ See discussion in relation to Figure 3.

¹⁴⁴ Boris Kagarlitsky, *Restoration in Russia* (London: Verso, 1995) 118.

¹⁴⁵ Reddaway and Gliniski 29, 307, 384, 385.

¹⁴⁶ Gill and Markwick 251.

threaten the viability of economic development; numerous strikes that took place in the 1990s¹⁴⁷ and continuous parliament opposition to many economic initiatives put forward by the Russian administration are just two examples of tensions that undermined the efforts of the government to stabilize the economic performance. Thus, lack of popular support, initially being an outcome of the adopted reform course, also became in many ways a cause of reform failure.

A viable middle class is another important pre-condition for a successful transition to capitalism. As Naumova points out, “[o]nly a strong and numerous middle class can serve as a bulwark of reform, ensuring ... economic growth and the economic effectiveness of reforms.”¹⁴⁸ The shock therapy of 1992- 1997 and the financial crisis of 1998 combined with the post-Soviet changes in income distribution “are indicative of a process of gradual disappearance of the Russian middle class,”¹⁴⁹ the very force that the Russian liberal reformers were counting on for support and promotion of the neo-liberal model of economic management.

In sum, it can be argued that the reforms could have had a different outcome had the Russian government chosen an alternative, moderate economic strategy utilizing some of the existing institutions, a strategy emphasizing social justice and public welfare and based on a mixed economic model with the elements of Keynesianism. According to Bogomolov,

[a] comparative analysis of the results of the reforms in the post-socialist countries makes it possible to draw an important conclusion: some continuity should be maintained with the socialist past; not everything has to be radically altered. The Soviet model, created on the principles of state ownership and centralized planning ... was in some ways viable, since it did ensure development (in some periods highly dynamic) of the economy and a rise in living standards. Its evident flaws... made it necessary to abandon the model. But this does not mean that the pages of history have no value at all and need to be rewritten entirely.¹⁵⁰

The uncritical embracing of an unsuitable developmental strategy based on the

¹⁴⁷ Gill and Markwick 232, 233.

¹⁴⁸ Nina Naumova as cited in Silverman and Yanowitch, 30.

¹⁴⁹ Tikhomirov 191.

¹⁵⁰ Bogomolov 101.

assumption that an unregulated market would always self-coordinate and would achieve, in all circumstances, allocative efficiency can be seen as the key explanation for reform failure.

4. An alternative developmental strategy

4.1. Alternatives: then and now

An argument has been presented in this essay to the effect that it was ideological and economic radicalism that is the root cause of Russia's failure to avoid the large-scale economic disaster of the 1990s. The neo-liberal development strategy uncritically embraced by the shortsighted and self-interested Russian government has bankrupted the country's economy and caused an unprecedented social decline. This paper has also argued that a moderate, social-democratic strategy based on traditions of mass social and economic creativity within the context of a genuinely democratic, socialized mixed economy could have been a better answer to the challenge of reforming the Soviet system. In the late 1980s and the early 1990s, it was still possible to reform the country's economy while retaining the major elements of a welfare state such as full or near-full employment, free health care and education, and a universal social safety net.

Today, a decade since the neo-liberal paradigm was adopted by the Russian administration, the country is in a different condition, whereby some of the more progressive policy alternatives that were available and could have been adopted in the early 1990s cannot be afforded and thus are no longer an option. A welfare state with full or near-full employment, free health care and education and a comprehensive social safety net is simply out of reach for the bankrupt Russian economy ten years after the

initiation of the neoliberal reform. Does this mean that there is no place for an alternative economic strategy for contemporary Russia? Given that certain progressive elements of the socio-democratic model can no longer be afforded, the only way to overcome the recent trends of economic and social decline is to combine and apply progressive policy alternatives that are still within reach. Among such measures are policies aimed at preserving democracy and civil liberties, promoting the development of civil society and democratic institutions, giving priority to production and decriminalization, and reversing some of the most controversial economic decisions taken under the Yeltsin administration. Most importantly, the state must be reformed to become less corrupt and bureaucratic and more effective and competent; it must start playing an active role in economic recovery and long-term economic development.

4.2. The role of the state

In the context of this discussion, it is instructive to consider the role of the nation-state in detail since the social democratic approach to reform places a strong emphasis on the concept of an activist state. Governments can stimulate, facilitate and support the development of competitive enterprises, as well as enhance the linkages between production, investment, trade, and technology. In Russia, however, no attempts have been made to influence the economy through the state's activist policies. One of the country's most fundamental problems is the weakness of the state; the government cannot even perform such essential functions as the enforcement of contracts or tax collection.¹⁵¹ The state withdrawal has been driven by the decline in revenues and this retreat has been forced and unplanned; as such, it is a highly damaging process.¹⁵² Thus, "[t]he major

¹⁵¹ Chrystia Freeland, "Not-so-badfellas," New Republic 10 December 1998: 18.

¹⁵² Thane Gustafson, Capitalism Russian-Style (Cambridge: Cambridge University Press, 1999) 213-214.

threat is that the Russian state may well become weakened beyond repair, while its core functions are being privatized by illegitimate and unaccountable forces, including corrupt officials and organized crime.”¹⁵³

The question of the state’s role for transitional economies is an important one. The concept of extreme dominance of the state should, of course, be rejected; but it is now time to acknowledge that “in the contemporary world building a capitalist system requires an activist state role and a considerable period of time.”¹⁵⁴ According to Stiglitz, “[t]here are certain areas of macro-economic management where central government-initiated action should be the norm.”¹⁵⁵

Traditionally, the state has a number of important economic functions. It provides essential infrastructural support, maintains order in society, establishes a set of economic policies, changes domestic economic arrangements in response to the changing demands of the world economy, provides necessary training for the labour force and so on.¹⁵⁶ Besides promoting economic growth, governments are also involved in the process of redistribution of resources through taxation and welfare plans and in other aspects of social development.

There are only a very limited number of nation-states (if any at all) where governments do not interfere with the market; most present-day economies are mixed ones - a fact which implies that a certain degree of state intervention should not only be accepted but also encouraged. Therefore, most governments are involved in managing the national economies through regulations, policies, standards, and rules. Another important function of nation-states is development and implementation of a set of rules

¹⁵³ Reddaway and Glinski 3.

¹⁵⁴ Kotz, David. “Capitalist Collapse: How Russia Can Recover” *Dollars and Sense*, (Issue 220, 1998): 11.

¹⁵⁵ Stiglitz, “Whiter Reform? Ten Years of the Transition,” 26.

¹⁵⁶ Alan Thomas, *Poverty and Development in the 1990s*, (Oxford University Press, 1992) 131, 132.

and policies to be adapted for international interactions. Governments sometimes protect domestic producers from international competition by trade controls that include tariffs, import quotas, subsidies, and licensing.¹⁵⁷ There are a number of important roles – such as imposing order and collecting taxes – that only the state can perform. Moreover, “severely weakened states will encourage conflict, as they have in Africa, Central America, and elsewhere.”¹⁵⁸ Sen argues that public policy is important for successful development strategy:

... positive state activities have played quite a considerable part in the historical process of economic development. ... In addition to favoring general economic development, any responsible state has to consider issues of equity and disparity.¹⁵⁹

Generally, the government is an institutional arrangement that compensates for market failures, provides public goods and deals with externality issues.¹⁶⁰ According to Lall,

... in theory, an active role may exist for governments to improve the functioning of markets. In practice, many governments have played just such a role, and gained unprecedented success for their countries as a result.¹⁶¹

While neo-liberal developmental strategy has recently advanced throughout most of the world, can we reasonably assume that state-minimizing policies have been closely followed by the world's leading economies? Judging from data on government spending, shown in Table 6 below, the state has never really abandoned its functions in the G-7 countries even during the Reagan-Thatcher era, when the ideology of “laissez-faire” economics reached the peak of its popularity.

¹⁵⁷ Thomas 131, 132.

¹⁵⁸ Jessie Matthews, “Power Shift: The Rise of Global Civil Society,” *Foreign Affairs*, (Jan/Feb 1997, Vol. 76):58.

¹⁵⁹ Amartya Sen, “What’s the Point of a Development Strategy?” *Development Economics Research Programmed Paper*, London School of Economics (April 1997): 4, 5.

¹⁶⁰ R. Mendez, “The Provision of Financing of Universal Public Goods,” in M. Desai and P. Redfern, (eds.), *Global Governance*, (London: Printer, 1995): 57.

¹⁶¹ Sanjaya Lall, “TNCs: The New Custodians of Development?” in R. Culpeper, A. Berry, and F. Stewart, (eds.) *Global Development Fifty Years After Bretton Woods*, (New York: St. Martin’s Press, 1997):179.

Table 6. The role of the state: G-7 countries
Government spending as % of gross domestic product¹⁶²

	1980	1996
Canada	38.8	44.7
France	46.1	54.5
Germany	37.9	49.0
Italy	41.9	52.9
Japan	32.0	36.2
UK	43.0	41.9
US	31.8	33.0
Average	38.8	44.6

Source: Irving Michelman, "The March to Capitalism in the Transition Countries" (1998), p.166.

During the period 1980 to 1996, social services and welfare payments alone averaged 25 to 30 percent of budget in the G-7 countries.¹⁶³ Furthermore, the state as a taxation agent collected 36.2 percent of wages in taxes in 1978 and 38.7 percent of that in 1995.¹⁶⁴

Thus, both the levels of spending and taxation point out the fact that, minimalist rhetoric notwithstanding, the state continues to play an important role in the economies of the world's most economically developed countries.

In light of the above analysis, it appears that the state plays a fundamental role in economic development in advanced and developing economies alike. A successful transition to a socially oriented market economy is nearly impossible to achieve in the absence of effective public institutions and a more activist role for the government. An economic model of this orientation would include the following essential features: a mixed economy representing both the private and the public sectors with strategic industries under public control; a coordinated macroeconomic policy on a national level; and a re-distribution policy aimed at providing a social safety net for those affected by

¹⁶² The comparable figures for Russia are: 28 per cent of GDP in 1994; and 21.8 per cent of GDP in 1997. Sources: UNDP, *Human Development Report 1997* (New York: Oxford University Press, 1997) 222; The Economist, *Pocket World in Figures: 1997 edition* (London: Profile Books Ltd., 1997) 178.

¹⁶³ Irving Michelman, *The March to Capitalism in the Transition Countries* (Brookfield: Ashgate, 1998) 166. In contrast, total social spending in Russia has been only 12.6 per cent of GDP, as Table 3 shows.

¹⁶⁴ Taxes on wages for an average one-earner couple with two children in the G-7 countries; cited in Michelman, 166.

loss of income or other similar factors.

The World Bank's 1997 World Development Report has re-evaluated the Bank's earlier approach to the relationship between state institutions and developmental strategies for transitional and developing countries, turning from the concept of minimalist state to a "state-friendly" outlook. In a noteworthy modification of the Bank's ideology, it was concluded that "[h]istory has shown that development requires an effective state. Stateless development as well as state-dominated development have failed. The state is central to economic and social development, not as a direct provider of growth but as a partner, catalyst, and facilitator."¹⁶⁵

4.3. Transition to an alternative developmental strategy

In today's interconnected world, a transition to a market economy in practice implies a wider process of integration with the global economy, with all the opportunities and challenges that such economic globalization presents. Thus, it is essential to consider how a transitional country can integrate into the global economy in the most optimal and beneficial way, at the same time reducing the associated risks.

While the transitional and developing countries should attempt to integrate into the global economy, the retention of policy autonomy is essential to the success of such integration, as liberalization requires a new partnership between the state and industry. Both liberalization and integration should be implemented on a gradual basis; rapid integration of the LDCs in global markets often results in massive destruction of the national industries by international competition, as experiences of sub-Saharan African

¹⁶⁵ Leen Boer, "The State in a Changing World: World Development Report 1997," *Third World Quarterly* (Dec. 97, Vol. 18, Issue 5): 935.

and some post-communist states show.¹⁶⁶

What is an appropriate policy response to the process of globalization for developing and transitional countries? It appears that there is no universal policy mix that could be applied to different national economies with equal success. It is clear, however, that an effective policy of adaptation of national conditions to global competition would include a long-term industrial policy, measures to protect domestic infant industries, correcting reliance on long-term domestic investment as opposed to short-term foreign investment, promotion of research and development, improvement of economic infrastructure and provision of a social safety net.

In addition, governments should have the ability to create the necessary macroeconomic and market conditions in order to mobilize savings that can be transformed into long-term lending for enterprise development. Governments should retain enough policy autonomy in order to be able to reduce commercial, financial and investment risks associated with sharp tax increases, interest rate adjustments, or currency movements.¹⁶⁷

Many observers agree that a larger role for the state in protecting domestic industry and correcting markets is needed if developing countries are to succeed in the global economy. Thus, Lall shows that there is convincing empirical evidence in favor of a "strong custodian role for the government.. [and] careful selective and functional interventions."¹⁶⁸

According to Singh, developing countries should seek not a "close" but a

¹⁶⁶ John Sam, "Sub-Saharan Africa in Global Capitalism," *An Independent Socialist Magazine*, (Jul/Aug 99, Vol. 51, Issue 3): 13.

¹⁶⁷ James Mittleman, "The Globalization Challenge: Surviving at the Margins," *Third World Quarterly*, (Sep. 94, Vol. 15, Issue 3): 427.

¹⁶⁸ Lall 189.

“strategic” integration where the state plays an active role of not only that of a manager of a national economy, but also a mediator between the local and global economies.¹⁶⁹

Singh argues that one of the key elements is an active industrial policy:

...in mixed economy countries with reasonably effective states, the governments should pursue a dynamic industrial policy to bring about the desired structural transformations in the economy as speedily as possible, to achieve rapid economic growth.¹⁷⁰

While certain elements of globalization (such as export orientation and adoption of new technology) should be adopted, others should be rejected or reduced (short-term capital flows and dependence on borrowing from outside sources). According to Singh, industry protection, export promotion and performance standards are complementary policies that promote a strategic advantage over foreign competitors. Foreign direct investment should be discouraged, not encouraged, as the mainstream neo-liberal economic paradigm insists. Finally, governments should have an option to intervene by way of domestic price controls and by supporting their national technological systems.

In a similar fashion, Rodrik argues that it is not the high degree of liberalization and integration that creates national economic growth; developing countries should adopt a set of policy responses to be able to successfully fit into the new global economic environment; according to Rodrik, “openness is [only] a part of development strategy; it does not substitute for it.”¹⁷¹ Rodrik points out the unstable nature of the global economy that frequently produces large external shocks affecting national economies in an extremely negative way. A correct policy response to external shocks is critical for national governments of developing countries. A set of economic, social and political measures including the maintenance of a high rate of private and public domestic

¹⁶⁹ Ajit Singh, “Openness and the Market Friendly Approach to Development: Learning the Right Lessons from Development Experience,” *World Development* (December, 1994) p. 1811-1823.

¹⁷⁰ Singh 1811.

¹⁷¹ Dani Rodrik, *The New Global Economy and Developing Countries: Making Openness Work* (Washington, D.C.: Overseas Development Council, 1999) 2.

investment, and the establishment of institutions that manage social conflict should provide economic stability, especially during times of global 'turbulence.'¹⁷² It is not trade or the degree of economic openness that matters; what really matters is economic growth:

Governments and policy advisors alike have to stop thinking of international economic integration as an end in itself. Developing nations have to engage the world economy on their own terms, not on terms set by global markets or multilateral institutions.¹⁷³

Several case studies of countries belonging to the "Asian Miracle" group (South Korea, Taiwan, Malaysia, Thailand, and Indonesia) also seem to support an interventionist developmental model:

A number of detailed academic studies of East Asia found that 'developmental' states had indeed played notable roles in shaping the direction and growth of their economies, through a broad array of regulatory institutions, market-guiding policies, and even protectionist support for national industries.¹⁷⁴

Governments of East Asian countries intervened heavily in all spheres of their economies during the periods of fast industrialization and at the same time avoided close integration with the world economy in the sphere of finance during their high growth phase.

East and South East Asia, which were the only regions to escape stagnation or decline in the eighties, were led by countries whose defining characteristic was the fact that they protected and used their sovereign power to pursue national development strategies focusing on the creation of a strong national industrial and technological base, dense networks of domestic economic linkages, and relatively equal income distribution.¹⁷⁵

The general observations and conclusions cited above once again confirm that the set of policies chosen by the Russian administration has not been an adequate response to the challenge of transition. An alternative strategy is the subject of the next section.

¹⁷² Rodrik 4 -10.

¹⁷³ Rodrik 4.

¹⁷⁴ Ernest Harsch, "Africa, Asia and anxieties about Globalization," *Review of African Political Economy*, (Mar 1999, Vol. 26, Issue 79): 117.

¹⁷⁵ Manfred Bienefeld, "Assessing Current Development Trends: Reflections on Keith Griffin's "Global Prospects for Development and Human Society," *Canadian Journal of Developing Studies* (XVI, 3, 1995): 375.

4.4. Policy options

Outlined below are proposed policy options that may help to gradually overcome the economic and social difficulties present in Russia and described earlier. We have seen that these difficulties have been for the most part a product of an uncritical implementation of the neo-liberal developmental strategy in general and the almost total withdrawal of the state from the regulation of the national economy in particular.¹⁷⁶ It follows that the badly needed correction in the reform strategy must include the re-consideration of the role of the state as the top priority. Moreover, almost all of the proposed policy options will have to be either actively supported or implemented by the state apparatus.

While it could be argued that the proposed measures aimed at strengthening the state apparatus run the risk of that state retreating into authoritarian, dictatorial and/or bureaucratic rule, such a risk is both justified and manageable. First, a capable and stable state with an efficient and de-politicized civil service has a better chance of eventually progressing toward a democratic, market-oriented and decentralized system of law and order as opposed to a situation where the state is weak, divided, and chaotic. Secondly, the above risk can be actively managed by taking measures aimed at improving the selection and qualifications of officials, eradicating corruption through more adequate levels of pay within the administration, and reducing staffing levels to a reasonable size. The authoritarian tendencies can also be counterbalanced by further developing institutions of representative democracy, in particular though achieving a better distribution of power between executive, legislative and judicial branches.

The goal of this alternative policy proposal is to ensure the welfare and the

¹⁷⁶ Tikhomirov 259.

material well-being of the people through both enabling the economy to grow and introducing certain re-distributive measures. The means to achieve this goal are through implementing a set of policies that imply more reliance on the state and less on the market as a self-correcting agent. The policy recommendations fall into three categories: economic, social, and political. They are further grouped into short-term, medium-term and long-term measures in accordance with the expected time needed for the policies to be implemented and to take effect. The short-term policies represent the most urgent policy priorities that are, in effect, crisis management measures. Many of the policies placed in the medium-term and the long-term categories would require substantial levels of government spending and could be implemented only over a longer period of time due to present financial constraints. Thus, the short run measures can reasonably be implemented within 1-2 years; medium-run within 3-5 years; and long-run within 10 to 20 years. The outlined measures are interdependent by nature and must be taken simultaneously in most cases. It is hoped that the short-term measures combined with the present favorable economic climate due to high world oil prices can set in motion a process of positive cumulative causation that will gather momentum for further rises in incomes, demand and investment.

At this time, it is possible only to lay out the general recommendations. Given political and economic uncertainties, specific and more detailed recommendations are often not possible. Nonetheless, it is hoped that the general shape of recommendations is clear. The proposed measures may allow for a successful transition to a socially oriented market economy, initially creating the necessary pre-conditions for the stabilization of living standards, the gradual reduction of poverty and the income gap, and prevention of mass unemployment; and later leading to sustainable economic growth and social

stability.

4.4.1. Short-term policy options

1. Temporary industrial protection

The government should establish temporary protection of selected domestic industries and agricultural products in order to give national producers an opportunity to modernize and thus better compete with foreign firms.

2. Capital controls

A system that will control capital flows in and out of the country during the initial stage of the transition should be put in place. This will help stopping capital flight and will discourage dependency on short-term foreign loans. Closed capital accounts in China played a critical role in that country's economic success.¹⁷⁷

3. Reducing dependence on international financial institutions.

Many observers, both Russian and Western, agree that IMF's lending has been harmful to Russia's economy and national interests.¹⁷⁸ According to one estimate, "at least a third of budget revenues are spent on the servicing and repayment of foreign debts."¹⁷⁹ Thus, any new borrowing should be either significantly reduced or discontinued as soon as possible. This is entirely possible at the moment, since high global oil prices have been creating a budget surplus over the last two years.

4. Better redistribution through better taxation.

The flat rate taxation system currently in use does not provide for equitable distribution of resources and should be replaced with a well-enforced system of progressive taxation.

¹⁷⁷ Stiglitz as cited in Reddaway and Glinski, 303.

¹⁷⁸ See, for example, Nolan, Reddaway and Glinski, Chossudovsky, Sachs, and Bogomolov.

¹⁷⁹ Reddaway and Glinski 620.

Further, considering enterprises, Russia is a country of unpaid taxes.¹⁸⁰ Taxes must be collected in a more aggressive way from enterprises that refuse to pay them. Enterprises that are not able to pay salaries and/or taxes must be re-privatized.¹⁸¹ Additional financial resources provided by a better system of tax collection should be directed towards the formal system of social support.

5. Poverty Amelioration

Due to the higher incidence of poverty among seniors and children, the lowest pensions need to be increased and additional benefits provided to single-parent families.

6. Health Crisis Management

Access to a basic package of health care benefits should be guaranteed to those currently unable to afford medical services.

7. Promotion of food security for the poorest segments of the population

Although Russia's economy was suffering from economic decline throughout the 1990's, it can be argued that the state has enough resources to provide a guarantee of a minimum nutritional intake (using, for example, a food stamp scheme) for those in need.

8. Re-privatization

Enterprises that were given away or sold for less than their true value must be either re-privatized, or in some instances re-nationalized. This is especially important in regard to strategic asset industries such as transportation, energy, mineral extraction, and communications. The best mechanism to initiate this process is through judicial proceedings that will review the results of privatization where it is suspected a breach of the laws has taken place.

¹⁸⁰ Peter Boettke, "The Russian Crisis: Perils and Prospects for Post Soviet Transition," *American Journal of Economics and Sociology* (July 1999): 371; Braguinsky and Yavlinsky 223.

¹⁸¹ Meaning that the enterprise owners who are unable to properly manage it must be forced into bankruptcy and their property auctioned off.

9. The introduction of a new social contract.

While the old paternalistic social contract (which can be briefly formulated as, "Do what you are told and you will be taken care of") has been abandoned, there has been no consensus on what form the new social contract should take. This has led to a great deal of confusion in the Russian society as a whole.¹⁸² The new type of social contract should clearly outline the rights and responsibilities of both the general population and the government. The basic message could be elaborated along the following lines: "The government will assume the responsibilities of providing a safe environment free (as much as possible) of corruption and crime; and at least some minimum level of social safety net. The population will have to adjust to the new market realities and to work harder in order to succeed." In other words, the rules of the game should be made clear to both participating parties.

4.4.2. Medium-term policy options

10. Credit

Credit should be provided at low cost for productive uses in industry, construction and agriculture, while steered away from financial speculation.

11. Promotion of gender equity

Empowerment of women by ensuring equal rights and access to land, credit, job and training opportunities, and political participation is essential for achieving both social stability and economic growth. The most urgent policy actions in regard to the gender issue are opening all occupations to qualified persons irrespective of gender, providing pro-active employment and entrepreneurship programs for women, and promoting the

¹⁸² Braguinsky and Yavlinsky 193,194.

provision of child-care facilities to improve the labour mobility of women.¹⁸³

12. Creation of a new, socially useful third sector in the economy

This sector could provide goods and services that normally are not profitable in a free-market economy. Most importantly, this publicly subsidized socially useful third sector will provide unemployed people with a source of income (however small that income might be) and will play an important social integration role by transforming people's lives through meaningful employment and social involvement.¹⁸⁴

13. Judicial reform

One of the main objectives of the process of democratic state-building includes the creation of a stable society ruled by law. In this context, one of the main challenges to a successful transition remains the weakness of legal institutions and mechanisms to regulate business and competition and to combat crime and corruption.¹⁸⁵ Thus, a judicial reform that would include the building or restructuring of legal institutions into a viable legal system is long overdue. The rule of law, separation of powers and an independent judiciary are vitally important for the development of an effective market economy.

4.4.3. Long-term policy options

14. Public Spending

Public spending on science, technology, public health, and education should be gradually increased. Russia's financial loss from the decline of its science is estimated at \$500-600 billion annually.¹⁸⁶ Investing in public health and education will in part result in a more

¹⁸³ Monica S. Fong, *The Role of Women in Rebuilding the Russian Economy* (Washington, DC: The World Bank, 1993) 14-18, 30.

¹⁸⁴ Alan Lipietz, *Towards a New Economic Order: Postfordism, Ecology, and Democracy* (New York: Oxford University Press, 1992) 99-103; Jeremy Rifkin, *The End of Work* (New York: G.P. Putnam, 1995) 239-243.

¹⁸⁵ Sakwa 65-72

¹⁸⁶ Reddaway and Glinski 3.

efficient and more competitive workforce.

15. Poverty Reduction

The disturbing trend of increasing poverty can be reversed if poverty reduction is to be given a higher priority on a national level. Fundamentally, one of the most important pre-conditions for poverty reduction is the determination to address the issue of poverty.

A sustainable economic growth providing financial possibilities for boosting social expenditure is another such pre-condition. A long-term strategy aimed at mass poverty eradication should include the following elements:

- a) Increasing the guaranteed minimum wage level and old age pensions to the subsistence minimum;
- b) Eliminating errors in targeting. Studies indicate that while a significant proportion of the poor and the very poor do not receive any benefits from the government, households that are not poor often do receive public transfers.¹⁸⁷
- c) Reinforcing social protection of disabled, elderly, children, and other categories not capable of active work.
- d) Securing support for persons who have lost their employment; introducing active programs aimed at helping unemployed to re-gain employment.
- e) Re-establishing a comprehensive public welfare system that can be jointly funded by the government, trade unions and large corporations and that would provide temporary support and protection for those who have fallen below the poverty line.

16. Health Care and Education

Essential health care and free elementary and secondary education must be guaranteed to all. The authorities should determine the content of a realistic package of health services

¹⁸⁷ Jeni Klugman and Jeanine Brathwaite, "Poverty in Russia during the Transition: An Overview," The World Bank

and establish the necessary procedures and responsibilities for providing these services. Responsibility for the elementary and secondary education system should be assumed by the state; this system to be entirely financed through tax revenue.

17. Institutional development

It is important to restore confidence in state-power and to enhance its regulatory role. Measures should be taken to make the state administrative apparatus more competent, democratic, efficient, predictable, accountable and transparent, while less corrupt and bureaucratic. The power of the state should be used for giving reforms a social orientation, stimulating domestic production, and pursuing structural and development policies. Structures of law, finance, and regulation appropriate to the new economic environment must be developed and strengthened.

Promotion of the democratic system is essential; this includes free elections and constitutional changes to achieve a better balance of power among the executive, legislative, and judicial branches. The state will also benefit from the devolution of power from federal to regional and local authorities.¹⁸⁸ The government should also pursue an active labour-market policy and stimulate entrepreneurship.

18. Promotion of civil society

Citizen participation and engagement in national policy-making must be encouraged as much as possible. Citizens' movements and campaign groups can and should democratically define and shape the country's development path and policy priorities.

Research Observer (February 1998): 44.

¹⁸⁸ Braguinsky and Yavlinsky 198.

A policy matrix summarizing the above policy options and further categorizing them into economic, social, and political measures follows.

Table 7. Policy Action Matrix

	Economic	Social	Political
Short-term	1, 2, 3, 4	5, 6, 7	8, 9
Medium-term	10	11, 12	13
Long-term	14	15, 16	17, 18

5. Conclusion

In the late 1980s and the early 1990s, the Russian Federation was uniquely positioned for a successful transition to a mixed market economy with a social-democratic orientation.

While under socialism there was huge underachievement in relation to human and physical resources, a large potential existed for well-designed institutional change to produce a substantial and lasting improvement in economic performance. Unfortunately, this potential has been wasted. Yeltsin's attempt to instantly replace a failed communist utopia with a new, equally utopian economic regime based on radical deregulation, privatization, and economic austerity led not to a rational and consistent transition, but to a decade of turbulence, political instability, economic decline, and hardship for the vast majority of the population. The neo-liberal developmental strategy, uncritically adopted by the incompetent and often self-interested Russian leadership, led to the collapse of the welfare state and left the government with few financial resources needed during the time of transition. Withdrawal of the state from the regulation of the national economy has had a profoundly negative impact on economic development.

Thus, the central reason for the unsuccessful outcome of Russian economic reform has been a wrong policy choice. This project suggests an alternative set of policy options based on rational pragmatism and social-democratic values. The proposed strategy is based on the fundamental premise according to which the role of the state continues to be paramount in the ongoing development of democratic capitalism.

Three generalized lessons may be derived from the Russian transitional experience. First, a policy of attempting to radically shift all the parameters of a national economy over a short period of time has a high likelihood of ending in failure. Second, a pragmatic, gradualist approach to reform based on a country's needs, history, and stage of development is essential in designing a viable reform strategy. Third, institutional infrastructure and a coherent, effective state apparatus are necessary preconditions for both a successful transition to the market economy and sustainable economic growth.

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