III. Contrasting Economic Priorities in Russian Reform

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SHORTCOMINGS OF THE "WESTERN APPROACH" TO
RUSSIAN ECONOMIC REFORM

Contrasting Economic Priorities
in Russian Reform

Executive Summary

Arguably, a substantial part of the economic decline and political turmoil that have accompanied Russian reforms could have been avoided if the economic reform program had been more flexible, rather than initially following the theoretical blueprint of "Western approach" proponents. The reformers' political strategy for achieving stabilization was inevitably unworkable outside a rigidly hierarchical, authoritarian political context. Further, the reform program exacerbated Russia's production crisis by extending the dislocations that had resulted from the breakup of CMEA and the USSR. Whereas the revitalization of Russia's production system is a key priority among nearly all Russian analysts, "Western approach" proponents have proven to be more interested in facilitating the export of raw materials. Russia's economic turmoil, and the political instability that resulted, meant that foreign investment by mid-1994 was low and on the decline. New business start-ups (outside the shadowy realm of sidewalk kiosk enterprises) have also lagged since the Gaidar reforms began, and the reforms have created conditions which have imperiled Russia's research and development potential. The economic inadequacies of Russia's reform program, then, suggest that a more situation-specific approach than was offered by shock therapy proponents merits close scrutiny. There is persuasive evidence that the Russian, Chinese and Polish examples, considered together, lend scant support to the shock therapy idea.

Whereas monetarists argue that long-term inflation arises from too rapid an expansion in the quantity of money, prominent Russian economists maintain that inflation can effectively be controlled only if monetaristic measures are applied in conjunction with other initiatives. Inflation in Russia has primarily an institutional character, they argue, and Russia's economy does not react in textbook fashion to stringent macroeconomic policy. To effectively reform a command economy, it must be realized by planners that such an economy was intentionally structured to function without money. Important institutional sources of inflation in the Russian

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1 This is the third in a series of four papers on the subject. The first, "The Political Requirements of Effective Reform" was distributed by the Council on June 27, 1994; and the second, "Structural and Cultural Factors in Russian Economic Reform Planning" was distributed on August 5, 1994. The final paper is in preparation. [NCSEER Note.]
production system include monopolism of enterprises, the wide gap between internal and world prices, and inappropriate enterprise behavior growing out of long experience in the Soviet command system. Thus, on the one hand, there is widespread support among Russian economists for a decisive reduction of the government subsidies which help to sustain Russia's distorted production system. But on the other hand, they insist, it is necessary for the government to be involved in measures necessary to promote economic improvement. Subsidy reductions, they suggest, need to be thoughtfully applied.

Of course, improved production depends on investment. Russia needs massive capital investment to both replace old and obsolete equipment and rearrange the mix of production output. But neither the Russian government nor its citizens invested substantially in Russian industry during 1993. Instead, it is estimated that during that period about $15 billion was taken out of the country—or more than $1 billion per month, on average.

Total foreign investment in Russia was only 10.5 percent of the amount invested in China at the end of 1993. Even worse for Russia, only $1 billion in new foreign investment was expected in 1994. Adding further gloom to this unfavorable picture is the fact that nearly half of the foreign investments in Russia during the first quarter of 1994 were in oil and gas. This kind of investment, which is oriented toward extraction and exportation, is not the type Russia needs most to improve its production system.

The entrepreneurial sector has also suffered under "Western approach" initiatives. In our 1993 interviews with political and business leaders, we frequently heard the complaint that the Gaidar team had been largely inattentive to the acute needs of business people. This situation had not improved significantly by mid-1994, although entrepreneurship continued to be encouraged with words prominently, as it had been from the beginning of the Yeltsin-Gaidar reforms. Several governmental organizations were by this time devoted to entrepreneurship at the federal level. But rather than advancing overall entrepreneurial activity, these different bureaucracies seemed to be working at cross-purposes.

2 Illustrative of structural factors in the Russian economy which contribute to spiraling inflation is the burden that many enterprises carry, held over from the Soviet period, of providing housing, medical care, educational instruction, child care services, and several other kinds of benefits to their workers. But there is no place in the monetarist reform formula for such micro structural details as working out new arrangements for housing, medical care and education among enterprise personnel. When they see inflation they can see only money supply distortions in the long run, and they have no suggestions for confronting pressing near-term problems of enterprise structuring.

3 An appropriate contribution by Western advisers to Russian reform could have been to offer input that would have helped Russian planners develop measures to strengthen entrepreneurship in 1992 and 1993. Their writings of that period offer no evidence, however, that entrepreneurship was one of their central concerns.
Taxes have a firm strangle-hold on private business—extracting as much as 80 to 90 percent of reported profits. The predictable result is that an overwhelming proportion of business people hide income to avoid taxes—and to stay in business. Tax rates are only one of the problems. Repeated changes in tax regulations and in export-import tariffs and duties, and burdensome licensing requirements and regulatory provisions, have thrown up a formidable wall against new business starts. An additional problem faced by entrepreneurs is the virtual impossibility, in Yeltsin’s Russia, for entrepreneurs to secure long-term loans at interest rates that are manageable. This situation, which applied effective brakes to entrepreneurship, was clearly part of Gaidar’s reform agenda.

In 1993, Western governments and international financial institutions, if not prominent Western advisers, began to insist more urgently that Russian leaders intensify their attention to entrepreneurship. This stepped-up emphasis on private business came at the time that Yeltsin was trying to generate support for the upcoming April 1993 referendum. In a context of promises from Western governments of large money flows to Russia, Yeltsin won the referendum. Most of the money, however, never found its way to Russia. Yet, the entrepreneurship component of promised western assistance remained a high-profile topic. Russian leaders got the message, and it is widely believed by Russian analysts that the continuing, if unenthusiastic, attention to entrepreneurship among the Russian government has been partially a response to this pressure from Western leaders.

Russia’s research and development capacity is at risk. The nesting of civilian science and technology—particularly high technology R&D—in Russia’s military-industrial complex requires that conversion in the defense sector be carried out thoughtfully, if innovation is to be sustained and improved. But this was not a high priority item for Western advisers’ agenda, or for Gaidar. In mid-1994, it was still correct to characterize conversion efforts in this complex but critical sector of the Russian economy as largely spontaneous and inadequately planned.

The results of this poor planning have threatened to wipe out key portions of Russia’s scientific research and development community, with obvious long-term economic implications. With Russia’s scientific activity shrinking "spontaneously," production has recently taken a course of "primitivization." The good economic news for Russia in mid-1994 was that, consistent with IMF guidelines, inflation had been reduced to a monthly rate of five percent. The bad news was that the Russian government’s fixation on meeting inflation targets was, as many Russian economists saw it, propelling Russia swiftly and surely down the road toward Third World status.

While urging on Russia lessons from the early Polish experience with monetarist thinking, shock therapy advocates have demonstrated an impenetrable disinterest in China’s reform
efforts, arguing that the Chinese case is uninformative for the Russian situation. Monetarists have attempted to discount the Chinese example because of the considerable differences between initial reform conditions in China and Russia, but their analyses are too facile. We find scant evidence that "Western approach" proponents have earnestly tried to assess the utility of lessons from China for Russia and Eastern Europe.

Of course, it is important to identify dimensions of national economies which render them more or less comparable with other nations undergoing transition. We wish that Jeffrey Sachs, for example, would do more of that, rather than rigidly applying his perspective from Poland to the Russian case--and attempting, in the process, to discredit more studied and situation-specific approaches to economic reform. Overall, Poland’s reform record has been disappointing. In light of the Polish experience, it would be prudent for reform planners to search wherever they can to identify promising leads that might offer improvement over this undistinguished example of a shock therapy initiative. China shows that it is more than theoretically possible to promote market development without wreaking havoc on an economy in the process.

After several attempts at reform through shock therapy, proponents of this approach cannot claim a single success in maintaining an orthodox shock therapy program while nourishing democratic processes at the same time. The striking failure of the "Western approach" on both economic and political fronts may signal the final burial of the monetarists’ transition strategy and facilitate a clearing of the stage for more thoughtful development of economic policies--ones that mesh better with economic and political realities. Our optimism about the implications of this recognition for Russia is muted, however, by the insuperable fact that the political environment for economic reform in Russia has now been changed decisively and intractably for the worse.

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4 What started in Russia as an experimental test case for monetarism quickly exposed the unrealistic political expectations that the monetarists had held--expectations that the citizenry would remain passive as the national economy began disintegrating in response to the reformers’ actions, and expectations that the parliament would obediently accept Gaidar’s unstudied scheme without protest or moves to modify it. The reformers’ naiveté in operating from these assumptions is inexplicable and, we think, will be remembered as one of this century’s most notable, and predictable, fiascoes.
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That which remains unacknowledged [in economics], as I have tried to
make clear, is the substratum of beliefs that causes us to structure our
perceptions in terms of an ‘economy’ rather than a sociopolitical
order."

-Robert Heilbroner, Behind the Veil of Economics\(^1\)

What kind of market liberalism is it, which destroys the agents of the
market?

-Mark Masarskii, "Ta skorbliu po pogibshim predpriiatiiam"
("I am Grieving Over Lost Enterprises")\(^2\)

Introduction

Economic policymaking urgently needs to incorporate Robert Heilbroner’s insight that
economics is bound up in traditions, belief systems and visions, and therefore "that economics
is fundamentally an embodiment of the forces of morality and politics, interpreted broadly."\(^3\)
When the issue centers around priorities for economic reform, it is particularly vital that
analysts recognize, along with Heilbroner, that "more than one set of conceptual elements can
be formulated to explicate the problems to which economists set their minds," and thus that
"no single reading can be adjudged the Truth. I emphasize this statement," he adds, "because I
sometimes fear that economists more than scientists yield to the temptation of asserting their
belief systems as true belief systems." Economic science cannot determine the content of
concepts, even the concepts that are "building blocks of economic theory. . . . Of necessity,"
Heilbroner continues, "these concepts must embody the value-laden elements that is their
primary raison d’être." Thus "Ideology, or belief systems to give them their more acceptable
name, provide us with the comprehension by which the ‘natural’ world is identified as such.
Science then explores and examines the empirical data that this particular set of values
identifies."\(^4\)

\(^3\)Heilbroner, Behind the Veil of Economics, 34.
\(^4\)Ibid., 194-95. Emphasis in original.
Heilbroner thus highlights one of the principal sources of misunderstanding in the Russian economic reform debate. Reform thinking within the small cadre of government policy planners diverges from that of most other Russian analysts over priorities more than anything else—priorities which are undergirded by values which have tended to be seen as Truth by participants in this debate who disagree about the most appropriate reform path. The values which predominated in the Gaidar reform program were inspired by the monetarist paradigm, and elements of this approach linger under Chernomyrdin—even in the rhetoric of economic reform and in Yeltsin’s determined hold on the reins of decisionmaking at the expense of legislative checks on executive power. And the economic priorities of Russia’s reformers not only diverged sharply from the recommendations of Russia’s most prominent economists, but they were formulated without serious attention to alternative reform approaches which might have usefully informed planning for the Russian transition.

This is the third in a series of four papers examining the "Western approach" to economic reform in Russia, whose defining features we have discussed elsewhere. In this report, we inquire into the values and priorities which support the policy positions of "Western approach" advocates, on the one hand, and on the other, positions of a number of analysts who have called for a more evolutionary approach to Russian economic reform—one that would be tailored to specific features of the Russian economic system. Neither of these two camps is homogeneous, of course, but our focus will be on commonalities shared by representative members of both. Then we will examine one of the most striking manifestations of unswerving orthodox adherence to the monetarist prescription for economic reform among "Western

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1Lynn D. Nelson and Irina Y. Kuzes, "Shortcomings of the 'Western Approach' to Russian Economic Reform, I: The Political Requirements of Effective Reform." Paper prepared for the National Council for Soviet and East European Research, Washington, DC (June 1994). We take the term "Western approach" from Jeffery Sachs. (See, for example, Jeffrey D. Sachs, "Russia's Struggle with Stabilization: Conceptual Issues and Evidence." Paper prepared for the Annual Conference on Development Economics, The World Bank, Washington, DC (28-29 April 1994, 3.) This approach has been urged by advisers to the Russian government and international financial organizations, and endorsed by a number of leaders in the West. It was partially implemented beginning in January 1992 but was modified importantly over the course of the year. Some of these changes diluted the thrust of the "Western approach," certainly. But only in a rigidly authoritarian context can "pure theory" hope to survive, intact, the pressures of divergent interests. Inevitably, then, the "Western approach" has experienced a series of setbacks since late 1991, as well as repeated attempts by some Russian officials to bring Russian economic reforms more in line with fundamental tenets of the approach. Throughout this period, Western leaders, and especially representatives of the United States government and international financial organizations, have continued to argue that Russian policymakers should more unreservedly embrace reform strategies that are consistent with the "Western approach."

2See, for example, Peter Murrell, "What is Shock Therapy? What Did it Do in Poland and Russia?" Post-Soviet Affairs 9 (1993), 111-40.
approach" proponents: the continuing effort to discount China's notable success in following a gradual reform course.

In this report, we will not join the longstanding controversy among economists and other analysts about the theoretical soundness of general equilibrium theory. Our focus is more concerned with the constraints and requirements imposed by the Russian economy than with long-term theoretical expectations. The latter may be interesting academically but can hardly serve as a useful guide to policy--a point long ago recognized by John Maynard Keynes: "In the long run we are all dead." Keynes continues, "Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again." That is the chief policy failing of the "Western approach," we will argue. One distant vision whose promise was never realized had been quite enough for twentieth century Russia.

The Macroeconomic Stabilization Imperative

"Strengthening the ruble became the main priority of the first stage of reform, by firmly applying the brake of financial stabilization," Gaidar wrote in August 1992. The Gaidar reform program, by accepting the neo-liberal promise of long run gain through monetarist policies, developed a strategy that leaders of Western governments consistently avoid. Gaidar chose to advocate stringent monetary policies, under conditions of acute economic crisis, that were aimed at achieving long run goals with an unknown time line. The efficacy of this transitional strategy was also unknown. Monetarist theory was of questionable utility for a situation in which markets did not, for the most part, exist. In light of these uncertainties, most Russian economists advocated a less theoretically-driven approach--one which would have attended to critical near-term considerations that were necessary for sustaining reforms in a democratic context.

In August 1992, Gaidar attempted to distance himself theoretically from the "Chicago school," following accusations that he had succumbed to Western influences that were working against Russian national interests. But this was an impossible task, in the context of unreserved praise for Gaidar's reform program that was prominently visible during this period from "Chicago school" proponents in the West. Several months after Gaidar's reforms began, David Lipton and Jeffrey Sachs, for example, were crediting Gaidar with having "created an

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9Ibid.
enormous opening" for market relations by attempting a program of stabilization and liberalization,10 and Anders Åslund was loudly applauding Russia's reformers for having "launched its daring transition" with the immediate tasks of liberalization and macroeconomic stabilization. "The focal point" of the stabilization effort, Åslund continues, "was to balance the budget in the first quarter of 1992." And, he adds, "Their very impressive attempt succeeded amazingly well."11 With such unqualified endorsements from card-carrying monetarists, the Gaidar program was afforded no opportunity to effectively blur its "Chicago school" imprint. Gavriil Popov, Moscow's former mayor and a progressive democratic voice in Russia, was just one of many Russian analysts who argued that Gaidar was following a "Westernized" approach which, Popov maintained, was being promoted by the West to destroy Russia's military-industrial potential and ensure Western competitive economic advantage.12

At other times, Gaidar insisted that "Russia never had a policy of shock therapy."13 "We could not," Gaidar continued. "We were not able to simultaneously, immediately, correct all the serious structural macroeconomic and financial imbalances. . . . [W]e never attempted to stabilize the exchange rate, because we lacked the necessary currency reserves." Our reform, Gaidar repeated, "can never be put into the traditional scheme of 'shock therapy.'"14 Sachs, also, was insisting in 1994 that "'shock therapy' did not fail in Russia. It was never tried."15

This argument is a red herring. Shock therapy was not "tried" in the same way that communism was not "tried." They were not "tried" because the real world has never, at any time or in any place, fit the simplistic assumptions or met the necessary theoretical prerequisites of either the neo-liberal monetarist platform for economic reform or Marxist agendas for a communist society. Gaidar's words, quoted above, highlight just a small portion of a substantial package of untenable assumptions and unrealizable preconditions in the Russian case. And theories with pretensions of policy applicability cannot retain legitimacy if they can be played out only in the imaginations of the theorists. It is no justification for "Western

11Anders Åslund, "The Gradual Nature of Economic Change in Russia," in Changing the Economic System in Russia, ed. Anders Åslund and Richard Layard (New York: St. Martin's Press, 1993), 19, 22. Emphasis in original. This chapter was taken from a paper that was presented at a June 1992 conference—six months after the initiation of price liberalization in Russia.
13See, for example, Kim Sok Kwan, 'Nam udalos' dobit' sia glavnogo . . . ." Ekonomika i zhizn', no. 25 (June 1993), 7.
14Ibid.
approach" advocates that their theory did not mesh well with constraints that prevailed in Russia. A key to effective policy is to anticipate such impediments, rather than to use them as excuses in the aftermath of policy misjudgments.

Apparently having missed the lessons of the first two years of post-Soviet history, Gaidar continued to believe in 1994 that the primary focus of Russian reform should be financial stabilization. "First of all," he writes, "financial stability is necessary--the stopping of inflation and the growth of prices. . . . Such stability not only brings a person immediate psychological relief and makes his life predictable, but it also makes it possible to develop long-term plans. . . . It [financial stability] is the key to the overall stability of the country. From that will follow economic revitalization."16

Outside Russia, also, "Western approach" proponents still failed to acknowledge in 1994 the utopian character of the economic course they had advocated for Russia. "The so-called shock therapy approach to stabilization . . . is desirable." Jeffrey Sachs told participants in an April 1994 World Bank conference, "because it offers the most realistic chance of avoiding a political catastrophe."17 Such statements only make sense if seen as desperate efforts at image-building for the beleaguered monetarist formula, in the aftermath of the 1993 political conflagration in Russia which was directly tied to the monetarist-inspired reforms. The monetarist approach to economic transformation has been shaken to its foundations, along with Russia's economy, because the keystone of the monetarist strategy--a one-two effort to bring about liberalization and stabilization--was clearly responsible for a series of devastating shocks--and not only to the Russian economy, but to all of the country's non-economic institutions.

"The planned economy was specially created to function without money," economist Grigorii Yavlinskii argues. "That's why it does not react to stringent macroeconomic policy the way it is described in textbooks."18 Monetarists have a straightforward and simple solution for long-term inflation, for example. Print less money. "Always and everywhere," Milton Friedman insists, "long continued inflation is . . . a monetary phenomenon that arises from a more rapid expansion in the quantity of money than in total output."19 But Yavlinskii maintains that "to knock down inflation in Russia's economy in the near term is impossible," because its roots are deep and entwined with the structure of the economy.20 To effectively

19Friedman, Monetarist Economics, 22.
confront inflation, Yavlinskii argues, monetaristic measures must be applied, but in conjunction with other initiatives. "Our position," Yavlinskii’s YABLOKO faction stated in April 1994, "is that inflation in Russia has primarily an institutional, and not a monetary, character." Thus, "Purely monetary methods to fight inflation must be supplemented with real reform which can eliminate the causes of inflation," YABLOKO insists.21

There are a number of important institutional sources of inflation in the Russian production system, according to Russian analysts. Evgenii Yasin, a leading economist and head of the Analytic Center in the Russian government, pinpoints three: monopolism of enterprises, the wide gap between internal and world prices, and inappropriate enterprise behavior growing out of long experience in the Soviet command system. For example, price liberalization, rather than resulting in a leveling of prices, produced chaotic growth under circumstances in which enterprise directors continued accustomed methods in an altered economic environment. And research has found, Yasin notes, that the chief criterion of success for many directors continued to be "preserving the working collective and creating for it the best possible life conditions."22

Was monetary policy responsible for these results? Yes, Sergei Glaz’ev emphasizes. Glaz’ev is a deputy in the State Duma who had been a minister of foreign economic relations before he quit the government in September, following Yeltsin’s decree dissolving the parliament. Glaz’ev insists that the reformers should have known that market conditions cannot be created overnight when appropriate market behaviors have not been learned.23 Such factors as these, in combination, account for the failure of monetary policy to achieve the results that were intended, Yasin insists. He continues, "[T]he monetary part in our inflation--the part which can be eliminated through strict monetary policy--is a fairly small part of the total."24

Yavlinskii emphasizes another critical factor contributing to Russia’s spiraling inflation--the burden that many enterprises carry, held over from the Soviet period, of providing housing, medical care, educational instruction, child care services, and several other kinds of benefits to their workers. In a study of Nizhnii Novgorod’s enterprises, Yavlinskii found that "most of the state and post-state enterprises spend up to 80 percent of their profits to support the social infrastructure. That is why the first step on the way to structural transformation," he

24Yasin, "Starye diskussii i novye problemy."
insists, "has to be the separation of the social infrastructure from state and post-state enterprises." But there is no place in the monetarist reform formula for such microstructural details as working out new arrangements for housing, medical care and education among enterprise personnel. When they see inflation they can see only money supply distortions in the long run, and they have no suggestions for confronting pressing near-term problems of enterprise structuring. Gaidar, for example, acknowledged in 1994 that the "problem of the social sphere of enterprises, in which they have unavoidably been trapped," was not addressed in the reform program he initiated.

Government subsidies are a major source of inflation, of course, as these analysts recognize. On the one hand, there is widespread support among Russian economists for a decisive reduction of the government subsidies which help to sustain Russia's distorted production system. But on the other hand, they insist, it is necessary for the government to be involved in measures necessary to promote economic improvement. The subsidy reductions, they suggest, need to be thoughtfully applied. Neo-liberal monetarists argue against substantial government participation of this kind, however, thinking that it promotes resource misallocation, dampens investment from other sources, and leads to a variety of other negative outcomes. Gaidar's planners accepted this monetarist outlook whole cloth. Sergei Vasil'ev, who was considered the chief ideologist of the Gaidar team, is indistinguishable from Friedman on this point. "The government must limit its activity in the economic sphere to the maximum extent possible," Vasil'ev insisted in an April 1994 interview, "and let the market, money, and entrepreneurs work."

Most Russian economists, however are not monetarists, and they have consistently advocated a level of state participation in economic restructuring which would mean, among other things, continuing economic investments from the government in enterprise transformation. Vasil'ev answers this orientation by arguing that "The consequences will be corruption and a waste of money." This is populist "Chicago school" rhetoric in the familiar Friedman mold--a direct echo of Friedman's characterization of federal government activity in

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25Yavlinskii, "Inaia reforma."
27See, for example, Milton Friedman, Monetarist Economics (Cambridge, MA: Basil Blackwell, 1991), 50.
28Arkadii Sosnov, "Reformy konchil's? Zabud' te," Moskovskie novosti, no. 17 (24 April-1 May), B3.
29Ibid.
the United States. The government, Friedman asserts is "literally uncontrollable . . . feeding on itself--and us--and getting larger and larger like some enormous tumor."\(^30\)

Such pronouncements have never brought victory for fervent monetarism as the guiding principle of economic policymaking in the United States, of course, but in Russia, "Chicago school" advocates gained a unique hold on government decision-making beginning in late 1991-planning for, and initiating the implementation of, the most sweeping, massive and rapid governmental retreat from a national economy that the world had ever known. But what started as an experimental test case for monetarism quickly exposed the unrealistic political expectations that the monetarists had held--expectations that the citizenry would remain immobile as the national economy began disintegrating in response to the reformers' actions, and expectations that the parliament would obediently accept Gaidar's unstudied scheme without protest or moves to modify it, even as the predictions for the economy that were confidently voiced by Gaidar, Yeltsin and other government representatives proved again and again to be wrong.

The reformers' naiveté in operating from these assumptions is inexplicable and, we think, will be remembered as one of this century's most notable, and predictable, fiascoes. It was predicted, by a number of Russian analysts. Although the Gaidar planners failed to realize their objectives, and the program was quickly compromised, the Chernomyrdin government formed after Gaidar's departure has attempted to maintain a reformist image that would be pleasing to the West--even as the state bureaucracy has expanded and clear signs have appeared that branch ministries were winning their struggle to acquire renewed powers.

It was in this context that the Russian government prepared a budget proposal for 1994--a budget draft which would be submitted to IMF (the International Monetary Fund) for review before being delivered to the State Duma. When Russia's lawmakers were finally shown the budget proposal, Yavlinskii was one of many who objected to its priorities. "The draft for the federal budget does not reform to the necessary priorities in economic and social policy," the April statement by the YABLOKO faction argued.\(^31\) The government planners "are ignoring the most pressing problems of the present situation: the overall decline in production and the payments crisis." The statement continued, "They are not taking into account the most important elements of economic reform: structural transformation, support for


entrepreneurship, reorganization of inefficient enterprises, industrial policy, demonopolization, and social policy." 32

The Yavlinskii faction was one of several in the State Duma that found the budget proposal wanting and urged that it be reworked. Several consultations ensued with representatives from the Council of Ministers, but the government insisted that the budget had to be approved without modification. Ivan Rybkin, speaker of the State Duma, then called the Prime Minister in search of a solution to the impasse. But, according to Rybkin, Chernomyrdin was unwilling to consider a compromise. There is a demand that the budget appear to have been approved by April 20, Rybkin reported back to the lawmakers. It was April 14. In just six days negotiations were to begin on the $1.5 billion loan package which had been held up because the IMF had disagreed with Russia’s 1993 state budget.

Chernomyrdin’s government did not want to displease IMF again, whatever the concerns of the Russian legislators about misplaced priorities. The IMF was clearly a great deal more concerned with deficits than priorities regarding economic reinvigoration. Aleksandr Shokhin, the minister of economics, addressed the State Duma on April 15. In concluding his speech, he urged the deputies to approve the budget proposal "according to the instruction of the head of the government." Such uncompromising demands had become characteristic of Yeltsin-style "democracy," well before 1994. 33

Following the address, a Moskovskie novosti correspondent asked Shokhin what his real goal had been in the speech, because its heavy-handedness had even offended lawmakers who supported the budget proposal. Shokhin responded that he was doing his best to get the parliament to approve the proposal (or to appear to approve it, which is what happened that day), because it would give Russia the opportunity to receive the $1.5 billion IMF credits. 34 We will examine implications of Russia’s foreign aid "habit" in our next report.

Yavlinskii urged that the budget proposal be disapproved “because its current form means that the Russian economy will remain the same as it is now.” with continuing stagnation and production declines. 35 His objection was that too much emphasis was being placed on financial stabilization, through tax increases and reduced government spending—at a time when Yavlinskii believed that state investments needed to be increased to help restore Russia’s

32Ibid.
34Ibid.
production capabilities. The budget "is too severe for our ill economy," he insisted. He favored a governmental policy whose "essence is not self-elimination [from the economy], but the opposite--active involvement by the government" in a broad spectrum of areas. "This is the only way to realize financial stabilization," Yavlinskii maintained. "The main lesson from the experience of the past two to three years is that the state must play an essential role in the transitional period... Macroeconomic stabilization as the goal, which was put ahead of everything else, was a mistaken strategy from the very beginning."

Yavlinskii had been arguing this point from the early days of Gaidar's reforms, once the outlines of the government program became clear. He insisted in mid-1992 that "Under present conditions, financial stabilization can be only a temporary state, and one that can be achieved only at a very high price--a sharp decline in the standard of living and a deep drop in production." And Russia paid that price, at a markedly higher level than the reformers had predicted. Even the most fundamental understanding of economic principles renders Yavlinskii's conclusion compelling: "But it is these two factors in combination [a sharp decline in living standards and a deep drop in production] that are the most important preconditions capable of bringing a recurrence of imbalance in a short period of time. Therefore, economic policy should be reoriented toward long-term financial stabilization." Yavlinskii's perspective, in 1992 and also in the 1994 debate, was that the government's policy, which had been urged on Russia by the IMF and was consistent with the "Western approach," would in actuality lead to a heightened budget deficit, as Russia's economy worsened because of inappropriate attention to investments that could improve production.

Gaidar, in contrast, called for an overall reduction in government expenditures in 1994. "We must take the difficult path of reducing state expenditures to slow inflation," he argued, reciting the usual monetarist prescription. "The core of the problem in this situation is extremely simple," Gaidar stated. "With the existing level of inflation and level of taxation, no economic growth is possible."

But Yavlinskii insists that "It is not possible to achieve macroeconomic stabilization before a real private sector appears in the economy--before structural and institutional changes

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36Yavlinskii, et al., "Biudgzet--94."
37He writes here about demonopolization, the creation of a competitive environment, privatization with a strong emphasis on defense of property rights, the development of national industry, and the creation of an effective financial system (to support savings, capital investments, and growth).
38Yavlinskii "Inaiia reforma."
40Lopatnikov, "Situatsiiia--94."
are brought about.\textsuperscript{41} The sequencing he would prefer--with structural adjustment and institution building preceding macroeconomic stabilization--has characterized his approach from the "500 Days" program through the "Window of Opportunity" proposal until the present. And in 1992, when the outlines of the Gaidar program were becoming clear, Yavlinskii was quick to charge that the Russian government's emphasis on liberalization and financial stabilization over structural reform would not succeed. In May of that year he published a detailed critique, observing that financial stabilization had not occurred and pointing out reasons for the failure. "From the start, the economic policy of the Russian government has not had a conception of institutional transformations in the economy" [beyond privatization], he objected, and added, "Furthermore, such a conception was declared to be, if not of minor importance, then at least of secondary importance."\textsuperscript{42}

In his 1992 critique, Yavlinskii had elaborated on these points. "There is one extremely important circumstance that calls into question the effectiveness of the direct use of recipes from the neoliberal school of economic thought in reforming a 'post-plan' economy. This conception initially assumes the presence of a functioning market economy. . . . An accelerated changeover to 'playing by market rules even before the game itself starts' (for example, freeing up prices without an antimonopoly policy) in an essentially nonmarket economy will not lead to an accelerated transformation of the latter into a viable market economy but to its destruction, including the destruction of the few spheres that could have formed the framework of a future effective market economy."\textsuperscript{43}

Glaz'ev holds the same perspective. "We have not created the mechanisms of a market economy which make monetaristic policy effective in developed countries," Glaz'ev stated in November 1993, shortly after he left his government post.\textsuperscript{44} "In our situation, strict monetaristic policy can have only one effect." Glaz'ev continues: "a very deep decline in production. . . . The introduction of standard [macroeconomic] measures for transition to a market economy did not take into account the structural disproportions and existing 'rules of the game' on the micro level. As a result, the standard macroeconomic policy which had often been attempted in countries with market economies produced unexpected effects that were quite opposite from those that had been anticipated."\textsuperscript{45}

\textsuperscript{41}Ibid.
\textsuperscript{42}CDSP 44 (8 July 1992); from Moskovskie novosti (24 May 1992), 9-16.
\textsuperscript{43}Ibid.
\textsuperscript{44}Glaz'ev, "Bor'ba s inflatsiei."
\textsuperscript{45}Glaz'ev, "Uroki liberalizatsii v Rossii."
Concentration and Structural Distortions in Production

At the end of the Soviet period, industrial production was highly concentrated--in most sectors, in only one or a few enterprises. The 1991 report by the World Bank, et al., *A Study of the Soviet Economy*, illustrates this feature of the Soviet production system in noting, "For 87 percent of the 5,885 products included in the machine-building sector, a single producer accounts for all deliveries" to Gosnab (the State Supply Commission). "A similar picture emerges from disaggregated Goskomstat data," the report continues, "which indicate that some 30-40 percent of Soviet industrial output is composed of goods produced on single sites. For example, single factories produce 100 percent of sewing machines, 97 percent of trolley buses, 100 percent of cooking equipment, and so on." Russian industry at the end of 1993 revealed a similar pattern of concentration. About two percent of industrial enterprises produced more than 40 percent of all industrial products, and more than 80 percent of all production in most sectors came from one or two enterprises.

Most of these enterprises were large--substantially larger than their counterparts in Western countries. In late 1993, almost 90 percent of Russia's industrial potential was concentrated in enterprises with more than 10,000 employees each. Further, some appeared to be "significantly oversized," according to *A Study of The Soviet Economy*, with capacities that greatly exceeded demand for their output. The production system was weighted down with the output of heavy industry, and resulting inadequate production capacity for consumer products. And the military-industrial complex was overbuilt relative to other sectors. Eighty percent of the USSR's military production facilities were on Russian territory. More than 70 Russian towns still remained closed in mid-1994 whose inhabitants worked almost exclusively in military production and research.

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47"O sotsial'no-ekonomicheskem polozenii Rossii v 1993 godu" (po materialam Goskomstata Rossii), *Ekonomika i zhizn'*, no. 6 (February 1994), 7.
48Glaz'ev, "Bor'ba s inliatsiei."
52Yuri Shishkov, "Na puti k rynochnoi ekonomike," *Sotsiologicheskie issledovania*, no. 9 (1992), 75.
The tendency in Soviet and Russian enterprises "toward huge scale and extreme concentration" clearly resulted from preferences of central planners.\(^{54}\) In Russia's vertically integrated system, not only is there often only one producer of a product, or only two or three, but there is also often only a single buyer. This situation did not change substantially with liberalization and voucher privatization of enterprises. Thus, "most [production] enterprises still cannot choose the suppliers for the raw materials, machinery, parts and other supplies for production," Glaz'ev observes.\(^{55}\) With the beginning of price liberalization, this structure invited unchecked inflation through monopoly pricing.

With such prominent structural distortions in its production system, and the disruption of supply and distribution networks that was brought on by the collapse of the Council for Mutual Economic Assistance in 1991 and the subsequent dissolution of the Soviet Union, a continuing downturn in production was to be predicted in 1992. After the demise of CMEA, Soviet exports to former CMEA members dropped by 57 percent, and imports fell by 63 percent.\(^ {56}\) And with the dissolution of the USSR, linkages in Russia's production and distribution system were further disrupted. The Russian government's economic reform program, rather than responding to this emergency with measures to ease the precipitous slide in production, exacerbated the production crisis by bringing on further dislocations with its rapid-pace and oversimplified privatization program. The results of this multi-pronged assault on the production system were nothing less than catastrophic. From December 1991 until mid-1994, production in Russia declined by 53 percent.\(^ {57}\)

As Glaz'ev observes, "[T]here had to be a structural crisis, and it was natural that it was accompanied by a decline in production, because a large part of industry was oriented toward defense production. But a crisis should produce something new—not just reducing output in sectors that are not economically efficient. It should also create conditions for the flow of capital and resources in directions that would increase economic efficiency and facilitate the introduction of new technologies and the modernization of enterprises."\(^ {58}\)

According to the State Antimonopoly Committee, at the end of 1993 about 7,000 production enterprises continued to enjoy monopoly positions at either the federal or regional levels, in spite of the fact that a central objective of the government's economic program was


\(^{55}\)Glaz'ev, "Bor'ba s inflatsiei."


Leonid Bochin, head of the State Antimonopoly Committee, argues that the actual prevalence of monopolies was even higher at year's end than official figures indicate. Under new governmental regulations, to be considered a monopoly an enterprise now must control 65 percent of the market. In 1992 the percentage had been 35—a level of market control consistent with international classification norms. Thus, official data show, the number of monopoly enterprises was halved in one year—simply by changing the definition.

How should reforms have proceeded under these structural conditions? Under "Western approach" guidelines, the principal method of breaking up monopolies was to allow individual departments to privatize. Thus, for example, a transportation department of a production enterprise could set up its own autonomous transportation company. Rather than addressing the problem of product competitiveness directly, this procedure often contributed to production declines by making it more difficult and expensive for a production enterprise to do its necessary work. And the heart of the monopoly problem—the absence of a competitive environment for the main products of production enterprises, not just for the services of ancillary departments—was not skirted. Yeltsin adviser Petr Filippov recognized this deficiency, in retrospect: "All our attempts to scale down enterprises, to separate off transportation departments, or typography departments, did not produce any positive effect." 61

Yuriy Yaremenko, director of the Institute of Economic Forecasting, maintains that "The main defect of the course we are now on is that obvious and specific characteristics of the Russian economy were ignored. . . . The structural and technological disproportions which characterize our economy produce features of our economic environment which prevent the rise of a "self-starting market." 62 Economist Mancur Olson frames the problem similarly, arguing that "a thriving market economy is not, contrary to what some say, simply the result of 'letting capitalism happen'—not something that emerges spontaneously out of thin air. It requires a special set of institutional arrangements that most countries in the world do not have. The most prosperous countries happen to have these institutional arrangements, but they

60Andrei Borodenkov, "Raiskii lkumat dlia slonov," Moskovskie novosti, no. 45 (7 November 1993), 10A.
take them for granted. These arrangements are usually overlooked in ideological debate and in scholarly research."63

The effect of this narrow vision was that production was adversely affected by the monetarist-inspired reforms across a broad spectrum of economic sectors. As Glaz'ev points out, with the introduction of Gaidar's reforms, "production declined almost everywhere"—not just in overbuilt or high technology sectors.64 Stanislav Shatalin, one of Russia's most prominent economists, underscores the point. "I want to emphasize, first, that the decline in production does not have a structural but rather a universal character," Shatalin writes in early 1994, "and second—and most importantly—-that it struck the most progressive, high technology branches of production."65 And even the country's "loss-making enterprises using backward technologies and obsolete equipment . . . are not positioned haphazardly," Yaremenko insists. "They form complete chains, and by leaving them to their own devices we are rending the system of economic links and immeasurably aggravating old shortages."66

Production Improvement or a Focus on Raw Materials Export?

In light of defining features of Russia's production system at the beginning of the reforms, Yaremenko argues, the economy "needed to be prepared structurally, or parallel steps needed to be taken to build market relations and accomplish structural transformation." He continues, underscoring a critical priority for Russia which the West's monetarists seem intent on ignoring: "Under no circumstances should the fruits of the long-term industrial development of the country have been lost, but just the opposite. They should have been productively used. The cost of neglecting this accumulated potential will be immense, Yaremenko maintains. "I am deeply convinced that, as long as there are internal resources for structural and technological transformation, there is a future for our reforms. But if they disappear, the reforms have no future."67

The revitalization of Russia's production system is a key priority among nearly all Russian analysts. "Accelerated deterioration of whole industries is a direct route to overall economic collapse," Yaremenko maintains. Therefore, "Economic policy must once again

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64Ibid.
67Yaremenko, "Temp reformirovaniia poterian."
make production the top priority in decision-making." Yavlinskii’s prognosis for the alternative is grim. "Russia with its resources and human potential has to be a modern industrial country," he insists. "The approach from the position of vulgar liberalism today leads to hypertrophic growth of the primary sector, and the gradual elimination of processing industries. We are confident that this tendency has to be stopped."

But Åslund faults Russia’s economists for their "extraordinary emphasis on production," attributing this emphasis to the persistence of "old Marxist values." Such attempts at misdirection will not succeed, of course, where it counts the most—among the policymakers and citizenry of Russia who are not ready to accept Åslund’s invitation for Russia to devolve into a nation with Third World-like trading patterns. And that is very clearly what Åslund has in mind for Russia. By 1994 Åslund was insisting that "the structure of Russia’s total exports will change toward larger exports of raw materials." With such statements a part of the public record, it should not be surprising that a widespread conclusion now prevalent in Russia is that part of the Western advisers’ agenda for Russian reforms was to help make the Western world safe from the potential competition of Russian production.

Investment Requirements and Barriers to Investment

Improved production depends on investment, as economist Leonid Abalkin recognizes. The sharpest crisis is in the investment sphere, Abalkin wrote in July 1993, which to a great extent predetermines long-term tendencies toward further declines in production. In most branches of production, outside the military-industrial complex, a large proportion of machinery for production is old and much of it is obsolete. By one account, depending on the sphere of production, between 60 and 100 percent of equipment is worn out. (Among enterprises in the military-industrial complex, the situation is typically better.) According to the Center for Informational and Social Technologies of the Russian government, the volume of capital investment in industry needs to be increased by a factor of at least two, on a yearly

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69Yavlinskii "Inaia reforma."
basis, just to keep present equipment running, and current levels of investment would need to be raised by a factor of four to achieve significant economic improvement.74

Of course, a substantial proportion of present production operations should not be continued. Some of the output is not needed, and some production facilities need to be extensively modernized. This situation underscores yet another reason for sharply increased investment—to not only replace worn out and obsolete equipment but also to transform production methods in a large number of enterprises. But the recent trend has been in the opposite direction. From the beginning of 1992 until mid-1994, the level of capital investment dropped by 65 percent.75

Neither the Russian government nor its citizens invested substantially in Russian industry during 1993. Instead, it is estimated that during that period about $15 billion was taken out of the country—or more than $1 billion per month, on average.76 Capital flight, which had been ominous before October 1993, increased further with Yeltsin’s shelling of the Russian White House and accelerated even more with ultranationalist Vladimir Zhirinovsky’s December election success. Harold Malmgren, a former US trade representative, suggested at the beginning of 1994 that about $2 billion per month may have been leaving Russia by that time.77

Foreign investment in Russia by mid-1994 was low and on the decline. For comparative purposes we will highlight the situation in China, where foreign direct investment commitments rose from $7 billion in 1991 to more than $100 billion in 1993, while actual disbursements jumped from 1991’s $3.5 billion to nearly $25.76 billion in 1993.78 In contrast, according to deputy economics minister Yakov Urinson, total foreign investment in Russia by the end of 1993 totalled $2.7 billion—an increase of $1.4 billion for 1993.79 Foreign investment in Russia was only 10.5 percent of the amount invested in China at the end of 1993. And even worse for Russia, mid-1994 data suggest that perhaps as little as $1 billion in new foreign

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74Andrei Cherniavskii, "Investitsii i rynok," Ekonomika i zhizn, no. 20 (May 1993), 22.
75Boiko, "Parlamentskie slushaniia vymiraiut kak dinozavry."
76Lev Makarevich, "Inostrannyi kapital ne khochet idti v Rossiiu," Finansovye izvestiia, no 52 (29 October-4 November 1993), 3.
77"Utechka kapitalov iz Rossii dostigla 1,000,000 dollarov v mesiats," Novaja ezhednevnaja gazeta, no. 15 (26 January 1994), 1.
investment would be forthcoming in 1994, although some analysts were suggesting that with the post-voucher stage of privatization the 1994 level of foreign investment might match that of 1993. Adding further gloom to this unfavorable picture is the fact that nearly half of the foreign investments in Russia during the first quarter of 1994 were in oil and gas. This kind of investment, which is oriented toward extraction and exportation, is not the type Russia needs most to improve its production system. Overall, Russia has attracted only about 0.1 percent of foreign investment worldwide, and less foreign capital was invested in Russia by the end of 1993 than in Hungary ($5.6 billion), and Poland ($3 billion), for example. And Urinson noted that more foreign money had been invested in tiny Estonia (population 1.5 million) during the first six months of 1994 than in Russia. In 1993, United States firms invested $7 billion in China—10 times more than the $700 million invested by US businesses in Russia.

There are obvious reasons for Russia's poor showing. Russia's economy is in disarray, and the country has become politically and socially unstable. As we have shown in previous reports, these outcomes can be directly attributed, in substantial part, to the reform program that was initiated and, following inevitable resistance and revision, promulgated from 1992 onward. Not surprisingly, then, Euromoney's March 1994 country risk rankings, which periodically compare the risk of capital investment in different countries, placed Russia 138th out of 167 countries in the study. In contrast, China's Euromoney ranking (38th place) was higher than that of any East European economy. And a February 1994 study by the research department of The Economist, which compared the credit worthiness of 26 "emerging economies," ranked Russia 25th—only slightly ahead of Iraq.

In August 1993 we interviewed Aleksandr Radygin, head of the privatization department in Gaidar's Institute for the Economy in Transition and one of the authors of the Russian privatization program. Radygin acknowledged that "Gaidar had some illusions about the possibility of attracting foreign investors. In some ways, his was a theoretical scheme," Radygin said. "The reformers had expected that with price liberalization there would follow an effective anti-inflation policy, and along with privatization these developments would create the best conditions to attract foreign capital."

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80Ibid.
81See, for example, Bardin, "Investory reshili vziat' svoiu sud'bu v Rossii v sobstvennye ruki."
82"Luchshe rasschityvat' na sebia."
83Vinton, "... but Investment on the Decline."
84Henry M. Quinlan, "Chto za utechki kapitala?" Delovoi mir, no. 28 (10 February 1994), 7.
Pausing to note that these expectations were not realized, Radygin continued, "It's hard to imagine that any economist could propose a better sequence that would have worked. The low level of foreign investment is the most painful point for the Russian government," he continued. "But it's difficult to evaluate Gaidar's program. There's nothing to compare it with."

We wondered why he had not thought of China. China's evolutionary reforms have created an economic climate attractive to investors, and capital is pouring into the country at an impressive rate. Russia's hurried reforms have created such disarray that a great deal more money is flowing out of the country than is going in. We will return to the Chinese example in the concluding section of the report, where we will address the attempts by some "Western approach" proponents to downplay the implications of the Chinese approach for Russian reform.

Russian Reform and the Entrepreneurial Spirit

Elsewhere, we discuss the Russian government's neglect of the nonstate business sphere beginning in late 1991. A stream of legislation that was passed in the USSR during the late 1980s had established principles for cooperative enterprises--a development which was justified by Soviet leaders as being consistent with the goals of communism. By the time of the August putsch, more than 111,000 cooperatives were in operation. (Many more than this were registered but not operating.) The cooperative sector accounted for 6 percent of the Soviet Union's gross national product for 1991--about 17 times more than the cooperative contribution had been in 1988. Seven million people were working in cooperatives.

Most cooperative owners had actually wanted to be private business people, however, rather than participating in the building of "socialist enterprise." (In this report, we refer to "private" enterprise, as we are speaking of new businesses, not privatized enterprises.) On December 15, 1990, a law was approved in the RSFSR, On Enterprises and Entrepreneurship, which specified several legal forms of property ownership, including private enterprises. By 1991, most people who were beginning new businesses in Russia were

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89Vladimir Tikhonov, "Vlast' i rynok," Vek (Delovoi mir supplement), no. 11 (22-29 October 1992), 6.
91"O predpriiatiiakh i predprimatel'skoj deiatel'nosti," Ekonomika i zhizn', no. 4 (January 1991), 16-17.
private entrepreneurs, not members of cooperatives,\textsuperscript{92} and the number of private enterprises was growing rapidly.

But this trend was halted abruptly when Gaidar took the reins of economic reform. New business start-ups have lagged since the Gaidar reforms began, outside the shadowy realm of sidewalk kiosk enterprises. Russia’s encouraging potential for new production enterprises at the end of 1991 had been sharply reduced by mid-1994. "As soon as Gaidar came to power he became an opponent of entrepreneurship," Mark Masarskii maintains. Masarskii is an adviser on entrepreneurship to the Moscow government who became a prominent business leader during the Gorbachev era. Gaidar the academician had written favorably about the salutary role of entrepreneurs in an economy, Masarskii notes, and before joining the Yeltsin government he had been a strong supporter of Russia’s entrepreneurial pacesetters. But Gaidar the economic planner did not take into account the crippling effect of price liberalization and new tax policies on entrepreneurship. These measures drove many private firms out of business.\textsuperscript{93} Ironically, the actual number of small businesses declined during 1992—the first (and only) year that Gaidar headed the reform program.\textsuperscript{94} "It is paradoxical," Masarskii suggested in January 1993, "that under the ‘market-oriented’ government last year we [business people] were much worse off than under the ‘non-market’ government" in recent years.\textsuperscript{95}

Gaidar’s inattention to the entrepreneurial sector during the period that he headed the economic reform program is widely recognized. We heard this complaint repeatedly from political and business leaders and specialists we interviewed in 1993. "Gaidar never paid attention to the entrepreneur," Constantin Zatulin emphasized when we interviewed him in July 1993. A prominent Moscow businessman and State Duma deputy following the December 1993 elections, Zatulin expressed frustration that Gaidar seemed not to think it important that conditions be created which would be favorable toward private business activity. "He showed no sign that he saw entrepreneurship as being critical to economic reform," Zatulin indicated.

Economist Nikolai Shmelov maintained when we interviewed him in June that "Gaidar, Chernomyrdin, the Bolsheviks—\textbf{all} have artificially kept a lid on the natural energy of entrepreneurship"—which Shmelov described as "the energy of mushrooms breaking asphalt." In a \textit{Nezavisimaja gazeta} interview three months later, Shmelov charged that the reformers

\textsuperscript{93}Leonid Shinkarev, "Chastnoe delo millionov," \textit{Izvestiia}, no. 6 (14 January 1993), 5.
\textsuperscript{95}Shinkarev, "Chastnoe delo millionov."
"have not changed anything" in the private sphere. "They made it even worse, somehow, than it used to be. . . . You could be put in prison for private activity earlier, but economically it isn’t any easier now. There was a lot of talk, but the current powers continued to control—even worse, they made more difficult—the process of securing authorization to open a business."96

"To open my own production enterprise today would be as difficult as 60 years ago," Shmelov stated in our interview. "Gaidar talked about promoting private initiative, but he did nothing."

Masarskii insists that Gaidar understood from the beginning that state policy toward private entrepreneurship would have a dampening effect. "But Gaidar and I have different interests," Masarskii emphasizes. "He represents the interests of the state. That means the ‘apparatus.’" Gaidar represents "the power which is above the society and outside it—the power which has suppressed the civil society until now. . . . State priorities are different from the priorities of a civil society."97

This interpretation of the government’s position regarding private business underscores Lev Timofeev’s conclusion that "the ‘corporation of apparatchiks’ remains in charge of the life and future of the country, . . . and are using reforms in their corporate interest."98 The apparatchiks "are supporting initiatives and creativity only in their own circle, only for their own people, and only within the framework of their bureaucratic organization," Timofeev insists.99 Analyst Yakov Gilinskii concurs, arguing, "I am confident that the current powers . . . will never voluntarily agree to real reform. They will do their best to stay in charge. They will maintain all the obstacles . . . to retain all the ‘handles of power’ in their own hands."100

In our interviews with Russian business and opinion leaders, the net of blame for these developments was cast well beyond Gaidar’s circle of Russian reformers. Viktor Shchekochikhin, president of the Russian Union of Private Owners, told us in July 1993 that "the post-Communist regime which is declaring its commitment to the market doesn’t want to see private entrepreneurship develop. These people want to create pseudo-entrepreneurs. Shchekochikhin insisted---nomenklatura entrepreneurship. Gosplan entrepreneurship is developing."

96Vil’ Dorofeev, "Znaki vozrozhdeniia," Nezavisimaja Gazeta, no. 171 (9 September 1993), 5.
97Masarskii, "Ia skorbiu po pogibshim predpriiatiiam."
99Ibid.
Shchekochikhin continued, "It is shocking that the World Bank and the European Bank for Reconstruction and Development said that they were creating a special fund to support entrepreneurship. But," Shchekochikhin emphasized, "they don’t work with entrepreneurs. They go through the state sector, which isn’t interested in promoting private business. In practical terms, Western help doesn’t often reach private entrepreneurs. And it’s the same with the foundations that were organized according to government decisions," Shchekochikhin added. "They only pretend to support private entrepreneurs." Shchekochikhin was referring in particular to Gaidar’s All-Russia Association of Private and Privatizing Enterprises, which was created before the April 1993 referendum.101

As for the privatized sector, Shchekochikhin told us, "It is still close to the state sector—closer to it than to the private sector. Private entrepreneurs have nothing to do with privatization." And he elaborated in detail on his interpretation of Anatolii Chubais’s privatization program, arguing that "it achieves only one goal: to divide property into parts, which is just a continuation of the old socialist idea." The privatization planners neglected what should have been their main priority in privatization, Shchekochikhin suggested, which is how to create a real market and real entrepreneurship through the distribution of these vast holdings. "That is an entirely different issue from the one they addressed."

Noting that hardly any new production enterprises were started in the private sphere during the last half of 1991 or in 1992, economist Vladimir Tikhonov, a member of the Presidential Council, explores the reasons. At first, Tikhonov states, the primary culprit was the inaccessibility of production materials outside the state sector. Therefore, most of the capital of new entrepreneurs was kept in the monetary sphere.102 At the beginning of 1992, many private entrepreneurs thus had large reserves of capital that they wanted to invest in production enterprises.103 but this capital lost most of its value nearly overnight, with Gaidar's price liberalization. Further, the Russian government’s tax policies changed abruptly under Gaidar, and his value-added tax scheme was so burdensome for small businesses that many were forced to close. Writing about this development, Tikhonov maintains that "Many new entrepreneurs, because of unbearably heavy taxation, went into the ‘shadow’ economy."104

102Tikhonov, "Vlast’ i rynok."
103Fedor Rusinov and Mikhail Ioffe, "Rossiiskoe predprinimatel’stvo," Delovoi mir, no. 6 (14 January 1993), 12.
104Tikhonov, "Vlast’ i rynok."
Shmelov maintains that "the private sector was much better off under Gorbachev and Ryzhkov than under the democrats. The democrats not only failed to develop ways to stimulate private sector activity, but they have not even created conditions that would allow the private sector to be secure from the intrusions of bureaucrats and criminal groups," Shmelov charges. "They came up with the most foolish tax system in existence . . . The same with bank loans. If it is not possible to stop inflation now, the state must recognize that it is necessary to support the private sector--not just in words, but in reality."105

But that did not happen. Irina Khakamada, a deputy of the State Duma and former general secretary of Constantin Borovoi's Party for Economic Freedom, emphasized in mid-1993, "[U]ntil now, market reforms were . . . 'carried from above.' But entrepreneurs--the representatives of small and medium-sized businesses--have received only crumbs."106

This situation had not improved significantly by mid-1994, although entrepreneurship continued to be prominently encouraged with words, as it had been from the beginning of the Yeltsin-Gaidar reforms. Yeltsin established the Council on Entrepreneurship, an independent think tank comprised of Russian business executives, in March 1992. It was ostensibly created to provide a business perspective for governmental decision making, but its advice was largely ignored.107

Ivan Kivelidi, chair of a resuscitated Council on Entrepreneurship in 1993, observed that two earlier incarnations of this organization had existed previously--under Gorbachev and under Yeltsin. "But it turned out that, always, we played the role of 'housekeeper's children.' Everything that we worked on went into the trash can," Kivelidi complained. Kivelidi became a businessman in 1987, when he organized a cooperative and turned his first small business into an empire. In this July 1993 interview, Kivelidi asked, "Do our leaders actually support entrepreneurship as a way of life, as a system of values?" He continued. "Until now, it seems that [the Council's] ideas have been only slogans for politicians, for whom free entrepreneurship is an abstract idea, and even dangerous. It is a threat to their existence."108

In this context, initiatives have been announced which had the stated goal of promoting entrepreneurship but which, Kivelidi argues, were created for the benefit of "quick bureaucrats who seized a piece of our proposal in order to find 'a warmer place' for themselves." He then

105 "Realizm v politike" (round-table discussion), Nezavisimaya gazeta, no. 124 (5 July 1994), 5.
provided an example to support his charge. "Recently, the government announced that a Center on Entrepreneurship Development is being created, and a bureaucrat [rather than a person who knows entrepreneurship] has already been put in charge of it." The center is being created as a clearinghouse for Western investors, Kivelidi states, and the officials in charge of the Center will wield substantial power. To find the richest people in our country today, Kivelidi suggests, a person should look among bureaucrats, "because they have a fast-selling product which is in great demand--their signature. It gives them the opportunity to enrich themselves, while preserving an image of legitimacy."109

The trend Kivelidi decried in 1993 seemed to be continuing a year later. During May, Russia’s government completed a document aimed at showing support for small businesses. The Federal Program of State Support for Small Entrepreneurship proposed "to create good economic, legal, and organizational conditions" for small business.110 But details of the program did not live up to its billing. "It seems that the initial goal of those who developed the program was not as much to support entrepreneurs as to support those bureaucratic structures which want to continue leading and managing entrepreneurs, the same way they used to oversee state production," analyst Leonid Lopatnikov insists.111

By this time, there were several governmental organizations devoted to entrepreneurship at the federal level. There was a Federal Foundation to Support Entrepreneurship and Develop Competition. There were also four departments in different federal ministries which were intended to encourage private business. But rather than advancing overall entrepreneurial activity, these different bureaucracies seemed to be working at cross-purposes. "If a draft of a bill was prepared by the Antimonopoly Committee, the Ministry of Economics would never agree with it," Alla Aloian of the Federal Foundation observes.112 Lopatnikov describes this situation in similar terms, maintaining that the Federal Program was intended more to create an image of supporting entrepreneurs than to actually provide meaningful impetus to the development of the entrepreneurial sector.113 He pinpoints a critical reason for the competition among ministries for oversight of entrepreneurial activity, observing that the

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109Ibid. See also, Mikhail Leont’ev, "Ivan Kivelidi: Otnoshenie gosudarstva k predpriiatiiam ostaetsia po-prezhe naplevatel’skim, Segodnia, no. 86 (2 December 1993), 9.
113Leonid Lopatnikov, “A tsifry? Ikh prosto vy sherknuli . . . ,”
Federal Program of State Support for Small Entrepreneurship describes one of the principal coordination tasks of the state as "attracting foreign investments in small business."

"Is any comment needed?" Lopatnikov asks.¹¹⁴

"In spite of its repeated declarations," Aloian maintains, "the government does not consider the development of small business as one if its priorities." In highlighting deliberations within the government which surrounded development of the Federal Program developed in May 1994, Aloian charged that it "was not discussed with much interest."¹¹⁵

Lopatnikov concurs, maintaining, "The attitude toward small entrepreneurship during the past two years was, indeed, the Achilles' heel of governmental economic policy. Tax and other privileges which used to give the initial impulse to the creation of thousands of small... firms were eliminated."¹¹⁶

Adding detail to this point, Andrei Orlov, president of the Academy of Economics, describes a study of entrepreneurship which he completed in the spring, 1994. Orlov found that all levels of taxation, from local to federal, collect from 80 to 90 percent of reported profits from private businesses.¹¹⁷ "With today's level of taxation," Gilinskii stated in March 1994, "every enterprise and every businessman has to hide income to avoid taxes." The result of this situation was predictable. "Now, almost all private and most state businesses in all spheres--production and retail--are under the 'roof' of organized crime," Gilinskii charges, adding, "It is not possible to work and not break the law. . . . The criminalization of the economy is, to a great degree, the result of repressive activity of the state itself."¹¹⁸

In a similar vein, Nikolai Efimkin, director of a joint stock company with both production and retail branches, suggests that "everything possible has been done to annihilate this activity [entrepreneurship]. We all realize that entrepreneurship is being carried out in a criminal-like environment. But it is difficult not to support those business people who are saying, 'We are ready to work with racketeers, because they charge up to 10 percent.' The state takes up to 90 percent," Efimkin continues, "and with fines and a variety of sanctions, it takes even more."¹¹⁹

¹¹⁴Lopatnikov, "Chinovnikam--milliardy, predprinimateliam--obeshchaniia."
¹¹⁵Aloian, "Malyi biznes: problemy i prioritety."
¹¹⁶Lopatnikov, "Chinovnikam--milliardy, predprinimateliam--obeshchaniia."
¹¹⁸Kastravets, "Mafiia vsesil'na. A gosudarstvo?"
Tax rates are only one of the problems. "The results of tax policy are made even worse by repeated changes in tax regulations, in export-import tariffs and duties." Moscow business leader Mark Goriachev adds.\(^\text{120}\)

Further, Russia’s licensing requirements and regulatory provisions directed at private businesses throw up a formidable wall against new business starts. Orlov argues that state policy toward small businesses is oriented not only toward maximizing revenue for the state, but also revenue for state bureaucrats through the maze of regulations that invite bribery. It lacks a workable strategic plan for furthering entrepreneurship, he suggests.\(^\text{121}\) An illustrative example of the proliferation of licensing requirements can be seen in the fact that, as of mid-1994, a department in the Moscow city government which is devoted exclusively to licensing entrepreneurial activity just in Moscow has a full-time staff of more than 1,000 people.\(^\text{122}\) The director of the State Antimonopoly Committee’s Moscow branch, Oleg Novikov, observes that licensing requirements in Moscow "create barriers to any entrepreneurship activity in the city." These licensing requirements do not protect consumers. Novikov argues.\(^\text{123}\) When we interviewed him in June 1993, Novikov interpreted such impediments as strategies to preserve monopoly control. "There is monopoly at every level of government," Novikov insisted, "and people want to keep it that way." Aleksandr Ioffe, chair of the Moscow government’s Council of Experts on Small and Medium-Sized Businesses, maintains that "the absolute power of bureaucrats takes away people’s desire to be entrepreneurs even before they begin planning to own private businesses."\(^\text{124}\) Small business in the capital city develops mainly today through the support of the ‘shadow’ sector of the economy," Ioffe suggests. "because of the tradition of bureaucratism and extortion" which continues in Russia today.\(^\text{125}\)

An additional problem faced by entrepreneurs is the virtual impossibility, in Yeltsin’s Russia, for entrepreneurs to secure long-term loans at interest rates that are manageable. And this situation, which applied effective brakes to entrepreneurship, was clearly part of Gaidar’s agenda. "After the [April 1993] referendum, it became possible to increase control over monetary and budgetary policy," Gaidar stated in August 1993. "In particular, it was then possible to direct the Central Bank to increase interest rates--something that we were unable to do from May 1992 until April 1993. [Following the referendum], the interest rate was raised


\(^{\text{121}}\) Chirkov, “Malye shansy dla malogo biznesa.”


\(^{\text{123}}\) Ibid.

\(^{\text{124}}\) Malyi biznes khochet vyiti iz podpol’ia. Kto protiv?” Tsentr plus, no. 18 (1993), 3.

\(^{\text{125}}\) Stolichnyi biznes derzhitsia na ‘tenevikakh,’” Nezavisimaia gazeta, no. 111 (17 June 1993), 4.
from 100 percent to 110 percent, then 120 percent. Now it has reached 170 percent--about the current level of inflation. Unfortunately, the process is slow. We would, of course, prefer a more radical solution," Gaidar indicated. Thus the government cut off the lifeline of the entrepreneurial class who could generate the competitive vitality, and tax revenue, that drive a market economy.

A month before Gaidar wrote of this strategic "success" in getting interest rates up to the level of inflation, economist Vadim Medvedev, head of the Economic Analysis Group in the Gorbachev Foundation, wrote of the effect of these interest rates on private business. Loans are too costly for most entrepreneurs to use them for capital investment, Medvedev insists. Further, banks are very reluctant to make loans for longer than three months--which makes it virtually impossible to use loans to invest in production. Efimkin notes in May 1994, "Credit policy has come to a dead-end. Small enterprises--with very few exceptions--have stopped taking out loans. . . . But they cannot survive without loans." These considerations led Yavlinskii to argue that "The government must, with extreme urgency, create a system of state and private banks to provide long-term loans." Foreign advisers could have provided valuable advice to Russian financial specialists who have been socialized in the ways of Gosbank, but that was not a high priority among "Western approach" proponents. Indeed, the neo-liberal theory that set their course was entirely consistent with the high-interest strategy that was encouraged by Gaidar.

Most Russian economists agree with Ioffe that "Only the state is able to start the engine of entrepreneurship, to supply money for small businesses." At the time that the 1994 budget proposal was being discussed, Yavlinskii's YABLOKO faction objected that the portion of the budget aimed at supporting small business was less than 0.01 percent of the total. In the budget proposal "the share of state expenditures for institutional transformation is extremely low," according to the April YABLOKO statement. "The urgent tasks for economic policy

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128 Mikhailova, "Sozidatelem byt' vse trudnee."
129 Yavlinskii, "Inaia reforma."
130 Aleksandr Ioffe, "K nam--milosti prosim."
today are institutional and structural transformation. From this point of view, the 1994 budget does not provide the necessary vehicles to realize the most important economic priorities."

An appropriate Western contribution to Russian reform could have been to offer input that would have helped Russian planners develop measures to strengthen entrepreneurship in 1992 and 1993. Tikhonov told us in July 1993 that Sachs and Åslund had managed to convince Gaidar that price liberalization was needed late in 1991. It might well have been possible, along the way, to have discussed with him requirements for hardy entrepreneurship, but apparently they did not. And their writings of that period offer no evidence that entrepreneurship was one of their central concerns.

The problem here is that processes through which institutional and structural transformation of any kind can be effectively accomplished are largely unknown to monetarists. Sachs's "main pillars" of economic reform for Russia gave no standing to the urgent need for initiatives which could have promoted the private business sector. Instead, Sachs took heart that Moscow's "kiosk boom" provided good proof of "spontaneous market activity." What Sachs was seeing here, without recognizing it, was the spontaneous creation of a fertile field for mafia activity. But Russia needed more, from entrepreneurs, than imported soda, fruit punch and candy. It needed production. That was not part of Sachs's agenda.132 And Åslund, who has a great deal to say about stabilization and privatization of state enterprise, finds the subject of entrepreneurship un-compelling, except to complain that entrepreneurs often had to pay bribes.133 By trying to treat an infant market as if it were a mature one, in orthodox monetarist fashion, these advisers squandered the extraordinary opportunity that had developed by late 1991 to encourage vigorous expansion of Russia's private sector. As Masarskii describes this situation. "During the last two years, due to the efforts of our monetarists, hundreds of thousands of enterprises in the private sector were destroyed---enterprises which could have become the basis for efficient production. I grieve for those young plants that were trampled. What kind of market liberalism is it," Masarskii asks. "which destroys the agents of the market?"134

But in 1993, Western governments and international financial institutions, if not prominent Western advisers, began to insist more urgently that Russian leaders intensify their attention to entrepreneurship. This stepped-up emphasis on private business came at the time that Yeltsin was trying to generate support for the upcoming April 1993 referendum, where

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133 Åslund, "The Gradual Nature of Economic Change in Russia," 21.
134 Masarskii, "Ja skorbliu po pogibshim predpriiatiam." Emphasis added.
Russian voters were to express their overall opinions about the Yeltsin reforms. United States President Clinton strengthened this campaign, agreeing to hold summit talks with Yeltsin only three weeks before the referendum, and promising both a "new democratic partnership" and new US aid for food, housing, and entrepreneurship.135

The G-7 leaders soon joined this effort to bolster Yeltsin's credibility at home, pledging an aid package of about $28 billion a few days later. United States officials emphasized, at the time that the aid program was announced, that "the package could unravel if Russian President Boris Yeltsin fails" to win the referendum. The $500 million in seed money promised by the US was made conditional on matching contributions from other countries totaling $1.5 billion. Britain also agreed to provide technical assistance to develop industry, and Japan promised to furnish advisers for creating small businesses in Russia.136

Although Yeltsin won the referendum, most of the aid was not forthcoming. Sachs estimated in January 1994 that perhaps $4 billion of the $28 billion announced in 1993 had actually arrived.137 But the entrepreneurship component of promised western assistance remained a high-profile topic. By mid-1994, US House leaders Richard Gephardt and Robert Michel were complaining, in a memo to Secretary of State Warren Christopher and the Secretary of Defense William Perry, that "a strong sense of urgency . . . is conspicuously absent in the delivery of our assistance to Russia."138 And during the same period, Capitol Hill testimony was praising the potential of Clinton administration proposals for programs to encourage Russian entrepreneurship. For example, in a hearing of the House Appropriations Committee on May 10, Assistant Secretary of State Strobe Talbott highlighted the Clinton administration's "special emphasis" on providing support for new production and retail firms, and Representative Robert Livingston compared Russia to "a burned-out forest," whose young entrepreneurs "are like the seedlings coming up through the ashes . . . We want to make sure

137Jeffrey Sachs, "Betrayal." 14.
that they are cultivated and encouraged to whatever degree possible," Livingston continued, "and I guess that's really the essence of our program of assistance to Russia." 139

Russian leaders got the message, and it is widely believed by Russian analysts that the continuing, if unenthusiastic, attention to entrepreneurship among the Russian government has been partially a response to this pressure from the West. Writing in Kommersant-daily in May 1994, for example, Sergei Viktorov noted that Western governments and financial organizations "traditionally demand from Russia’s leaders support for small private entrepreneurship, in particular, as proof of their adherence to the course of reform." 140

"The state keeps its focus on large enterprises," business leader Aleksandr Volovik maintains, "mostly because it is easier to keep them in check." 141 A report prepared by a panel of prominent economists for Novaia ezhednevnaia gazeta at the end of 1993 goes further, concluding that, although the command system was swiftly demolished with Gaidar’s reforms, no satisfactory alternative system was created. Instead, the state bureaucracy came to see "in the emerging entrepreneurial class a threatening competitor." 142 Igor’ P’iankov, the president of a Moscow joint stock company, describes the outcome in vivid terms: “Business in Russia is very different from business in the West. An entrepreneur ‘over there’ ascends the stairs. Here, he hauls himself up a rope made from barbed wire.” 143

Research and Development at Risk

A shrinkage in the number of scientific personnel after the demise of the Soviet Union was inevitable as production was redirected away from its strong emphasis on defense. At the end of the Soviet period, about 80 percent of the work of scientific personnel in the USSR was connected with the defense sector, 144 and about 70 percent of the USSR’s scientific capacity was located in Russia. 145 Defense industries have long been the principal repository of


142“Krizis v Rossii budet preodolen v . . . godu,” Novaia ezhednevnaia gazeta, no. 57 (2 December 1993), 3.

143Ibid.


Russia’s best high technology scientific production. High technology civilian commodities, such as computers and even television sets, are still produced in defense enterprises, along with radar equipment and fighter jets. In 1993, 80 percent of the output of Russia’s military-industrial complex was for the civilian sector. These enterprises produced 100 percent of television receivers and 90 percent of the refrigerators made in Russia, for example.\footnote{Leskov, ""Oboronka' zakhvatila monopoliiu v oblasti kholodil'nikov"; and Igor' Achil'diev, "Oboronka pokazhiva," Megapolis-express, no. 1 (5 January 1994), 10.} Overall, it is estimated that the defense sector performed about 30 percent of Russia’s civilian research and development activity in 1993.\footnote{OECD, Science, Technology and Innovation Policies, vol. 1, Evaluation Report, 32.}

This nesting of civilian science and technology—particularly high technology R&D—in Russia’s military-industrial complex requires that conversion in the defense sector be carried out thoughtfully, if innovation is to be sustained and improved. But this was not a high priority item on the Western advisers’ agenda, or on Gaidar’s. And in mid-1994, it was still correct to characterize conversion efforts in this complex but critical sector of the Russian economy as largely spontaneous, and “inadequately thought-out.”\footnote{See Moisei Gel’man, "Polubeznadzornaiia konversiia," Delovoi mir, no. 113 (30 May-5 June 1994), 8.}

The results of this poor planning have been dismaying for Russia’s scientific research and development community. In January 1993, Shatalin’s Reforma Foundation and the economics department of the Russian Academy of Sciences issued a report evaluating the first year of reforms under Yeltsin. Observing that not even one goal of the stabilization policy had been achieved, the report charged that “tendencies leading to the destruction of the economy are gaining momentum,” among the most important of which are “the erosion of research and technological potential, and a massive brain drain.”\footnote{Dmitri Moskvin and Feliks Binshtok, “Gaidar’s Secret Plan: Once the Dear Country Will Awaken Poor,” Rabochaya tribuna (3 February 1993), 1-2. Available from "NEWS" library, "SPD" file, in Mead Data Central, Inc., LEXIS/NEXIS (database online).}

A 1994 report of the Organisation for Economic Co-operation and Development (OECD) discusses the brain drain now being seen through emigration and the movement of scientific personnel into other kinds of work within Russia. The OECD study suggests that perhaps 10 percent of Russia’s scientists and engineers have been lost through emigration (definitive and temporary), and adds that the impact of this movement "is not measured by numbers alone, as the emigrants leaving are in many cases people with international reputations and with marketable skills." In general, the report continues, "it is to be feared that certain highly
reputed scientific 'schools,' such as some in theoretical physics, will disappear, due to the dispersal of their personnel abroad."150

It is recognized by both Russian and foreign analysts that a large amount of Russian technology is not competitive in the world arena. More than 70 percent of all scientific workers, and of expenditures for scientific research, are in "branch science"--scientific work that was controlled by ministries in the Soviet system.151 The focus of branch science is largely applied, and branch science and technology organizations grew in the Soviet Union as much because of bureaucratic interests within the ministries as a result of real R&D needs in the society. In September 1993, a report on science and technology was released by the Ministry of Science and Technological Policy which stated that "branch science needs to be fundamentally restructured and reoriented toward the market." The report explained that "not more than 10 percent of branch science is competitive at the world level."152

Yet, a core of Russia's large branch science capacity is important to Russian production. OECD's 1994 report notes that "spontaneous reorientation" in the branch S&T system "carries the risk that organizations capable of succeeding in more stable market conditions may disappear, leading to an unnecessary erosion of the nation's research capability." The study further suggests that "If potentially viable elements of the branch S&T system are to be saved," then "strategically important S&T organizations" will have to receive "at least transitional state support."153

The good economic news for Russia in mid-1994 was that, consistent with IMF guidelines, inflation had been reduced to a monthly rate of five percent. The bad news was that the Russian government's fixation on meeting inflation targets was, as many Russian economists saw it, propelling Russia swiftly and surely down the road toward Third World status. "By the end of the year," Glaz'ev predicts, "the Russian economy will finally have a new structure--that of developing countries."154 "Irreversible deindustrialization of the country is proceeding full-speed," Glaz'ev warns, adding that the process has already gone so far that "We will never be able to restore a large part of our high technology production. We have already lost critical reserves that were necessary for future economic growth."155

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152Krylov, "Rossiiskaia nauka glazami evropeiskkh spetsialistov."
154Boiko, "Parlamentskie sushaniia vymiraiut kak dinozavry."
blame for this development, according to many Russian analysts, should be attributed to the erosion of the country's R&D capability, which according to the OECD report cited above, "may well be [Russia's] principal treasure" next to its abundant endowment of natural resources.\footnote{OECD, Science, Technology and Innovation Policies, 11.}

With Russia's scientific activity shrinking "spontaneously," production has recently taken a course of "primitivization." Innovation has waned, as investment has declined and R&D programs have been cut. This trend was intensified under Chubais's privatization drive, as large production units were often broken up into smaller, autonomous enterprises. Demonopolization would be good for competition, of course, if it were carried out in a way that would facilitate competitiveness; but the Russian way of enterprise fragmentation typically has had the opposite effect. These break-ups were carried out in the absence of a market structure or adequate market choices. Even worse for long term economic vitality, the new smaller firms lacked the resources necessary to acquire the technological knowledge which had been provided in the larger enterprises to which they had been attached formerly. As Glas'ev details this process, the breakup of production enterprises into smaller units, without careful prior planning, "is especially harmful for complex production systems. It destroys them. It provokes the new owners to simplify their production."\footnote{Glaz'ev, "Uroki liberalizatsii v Rossii."}

This trend could have primarily near-term implications, if Russia's R&D potential could be put "on hold," in the way that corporations lay off assembly line workers until business picks up. But science does not respond well to such shocks of discontinuity. Vladimir Fortov, chair of the Russian Foundation for Basic Science,\footnote{The OECD report Science, Technology and Innovation Policies translates this as "Russian Foundation for Fundamental Science" (p. 29).} surveys the prospects for science in late 1993. "We are catastrophically losing our scientific leadership and our scientific training institutions." Fortov warns. "The level of scientific studies is dropping, as is the production of scientific journals and books. Young people are leaving science and technology for business or to go abroad." Agreeing that Russian science has traditionally been overstaffed, Fortov continues, "The paradox is that we are losing, not only the 'excess,' but the focal points as well."\footnote{Andrei Vaganov, "'My bezdarno teriaem nauchnye shkoly," Nezavisimaja gazeta, no. 165 (1 September 1993), 6.}

Evidence for Fortov's contention can be found in signs that some highly reputed scientific 'schools' may soon disappear, and also in current funding trends. OECD estimates

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\textsuperscript{156}OECD, Science, Technology and Innovation Policies, 11. \\
\textsuperscript{157}Glaz'ev, "Uroki liberalizatsii v Rossii." \\
\textsuperscript{158}The OECD report Science, Technology and Innovation Policies translates this as "Russian Foundation for Fundamental Science" (p. 29). \\
\textsuperscript{159}Andrei Vaganov, "'My bezdarno teriaem nauchnye shkoly," Nezavisimaja gazeta, no. 165 (1 September 1993), 6.
that, once figures are corrected to correspond to OECD norms, R&D investment was approximately 1.4 percent of GDP in 1991, which "places Russia at the level of the OECD country average." But actual expenditures (not amounts budgeted) for basic science in 1992 were a great deal lower than in 1991---dropping to one-third of their 1991 level in just one year. And the loss of support for basic research was much more harmful than is suggested by these overall figures, because at the same time that total funding for science was rapidly shrinking, allocations within the budget which went for research were being cut even more drastically. In 1991, 50 percent of the money allocated for basic science was used to pay the direct expenses of scientific research, beyond the costs of salaries and overhead. In 1992, only three percent of the sharply-reduced budget for science was for such direct research expenses---or 1/50th the funding level of a year earlier. The rest went to salaries and overhead costs. And salaries for scientific personnel were very low. In early 1993, salaries in the scientific sector were 30 percent lower than in the country overall, but in the late 1980s they had been 20 percent higher. Not surprisingly, then, the number of scientific workers dropped by a third from 1991 to mid-1993.

Disinterest among Western advisers in Russia's R&D capability has an obvious rationale. A high level of native technological and scientific expertise is not necessary for raw materials export to countries which are capable of providing their own teams of experts. The Russian government's neglect of this worsening problem, however, is more difficult to understand. YABLOKO's objection to the Russian government's 1994 budget proposal was partially based on its inattention to this area. As Khakamada states this criticism, "Spending for basic research and support for scientific-technological progress is unjustifiably low. It is probably the country's only hope for competitive potential, not counting raw materials."

In Russia, the government is almost the only sponsor of scientific activity. There are only a handful of foundations to support scientific work, and those that have been formed have inadequate resources. There are only a few private research institutes. Private and corporate sponsorship of a larger portion of scientific research may grow, but R&D demands cannot be

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161Evgenii Semenov, "Nauka vozrodit'sia vmeste s gosudarstvom," Delovoi mir, no. 103 (3 June 1993), 11.
163OECD, Science, Technology and Innovation Policies, 56.
164Evgenii Vasil'chuk, "Nauka stanovitsia zhertvoi ekonomicheskogo krizisa," Finansovye izvestiia, no. 48 (1-7 October 1993), 1.
165"Novyi biudzhet: ni vashim, ni nashim."
166Khakamada, "Liberaly obediniautsia."
neglected in the meanwhile without the inevitable result of further economic decline. Because of these considerations, Yaremenko insists that it is "impermissible" to sacrifice the country's research and development potential to the "imperative" of "the deficit-free budget."\textsuperscript{167}

**Lessons from Poland and China**

An outline of "Western approach" priorities for post-Soviet reforms was furnished in Lipton and Sachs's first 1990 contribution to the *Brookings Papers on Economic Activity*, where they outlined their "ideas about the basic strategy for a package of comprehensive reforms" for Eastern Europe in general, and particularly Poland.\textsuperscript{168} In presenting their economic logic, Lipton and Sachs note that repressed inflation "is a fundamental factor in many of the deepest economic problems" of these countries, including "chronic shortages, poor export performance, the weakness of private firms trying to compete with state firms, and even the widespread corruption of state managers."\textsuperscript{169} But, they continue, these problems are often not as intractable as they seem. "A strong dose of macroeconomic austerity" can substantially alleviate many of them.\textsuperscript{170}

Most Russian economists have insisted that this "Western approach" was certain to prove unworkable in placing primary emphasis on macroeconomic stabilization. It has turned out that the Russian economists were right. In the former communist countries that have attempted the shock therapy approach, inadequacies of this course have inevitably required that it be redirected, and redirected quickly--but with severely damaging economic and political fallout along the way.

While urging on Russia lessons from the early Polish experience with monetarist thinking, shock therapy advocates have demonstrated an impenetrable disinterest in China's reform efforts, arguing that the Chinese case is uninformative for the Russian situation. It is that neglect that will be the focus of our analysis below.

John McMillan and Barry Naughton describe a feature of the Chinese economy that is of critical importance for the Russian situation as well. "All the institutions of the planned economy [in China] were developed as component parts of that system," they observe. "They are mutually consistent, but incompatible with a true market economy." What would be the effects of shock therapy in such a situation? "A big-bang transition can indeed cause the


\textsuperscript{168}David Lipton and Jeffrey Sachs, "Creating a Market Economy in Eastern Europe: The Case of Poland," *Brookings Papers on Economic Activity*, no. 1 (1990), 78.

\textsuperscript{169}Ibid., 89.

\textsuperscript{170}Ibid., 89.
interconnected socialist system to collapse." McMillan and Naughton acknowledge, but add, "But there is more to moving to a market economy than just removing government controls. New institutions must be created."171

In retrospect, McMillan and Naughton conclude, China’s impressive economic reform achievements resulted from a "massive entry of non-state firms," a "dramatic increase in competition, both among state firms and between state firms and non-state firms," and "improvements in the performance of state-owned firms resulting from state-imposed market-like incentives." Thus, they suggest, "China shows the potency of the fundamental market forces of entry and competition. China’s example does not however, justify laissez-faire; the state must monitor firms during the transition."172 And as for privatization, they argue that the Chinese experience shows that "Rapid privatization need not be the centerpiece of a reform policy."173

Shock therapy proponents virtually ignored all of these lessons in Russia. In an October 1993 paper, Sachs and Wing Thye Woo summarize their arguments against looking to the Chinese experience for insight into optimal reform strategies for Russia and other countries of Eastern Europe and the former Soviet Union (EEFSU). Their presentation illustrates the slips in logic and failure to furnish tenable supporting evidence that are hallmarks of ideologically-driven analysis. Here, we will review central points in their argument.

It is correct, as Sachs and Woo argue, that in China "the transfer of workers from low-productivity agriculture to higher productivity industry" was simpler than the kind of structural adjustment required in the EEFSU because industry there "is overbuilt" and "virtually all workers [in the EEFSU] before 1992 were in jobs heavily subsidized by the state."174 But Sachs and Woo do not recognize that these are arguments against—not for—shock therapy in Russia. Their point suggests that in Russia, even more studious attention to reform mechanisms is required than was needed for China—attention specifically geared to Russia’s particularly thorny industrial production problems, which were not as severe in China.

Overall, Sachs and Woo’s attempt to discount the Chinese example because of the considerable differences between initial reform conditions in China and the EEFSU is too

172McMillan and Naughton, "How to Reform a Planned Economy: Lessons from China."
173Ibid., 132.

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facile. Their presentation would be more credible if Sachs were as intent on identifying bases for noncomparability in the cases he wants to cluster together—such as Poland and Russia—as he is in pinpointing divergences between those that he does not want to compare, such as China and Russia.

Of course, it is important to identify dimensions of national economies which render them more or less comparable with other nations undergoing transition. We wish Sachs would do more of that, rather than rigidly applying his perspective from Poland, for example, to the Russian case—and attempting, in the process, to discredit more studied and situation-specific approaches to economic reform. There are a number of factors which render hazardous certain types of comparisons between Russia and China, and also between Russia and Poland. Not only was Poland’s economy so different from Russia’s at the beginning of reforms as to make a uniform approach to marketization in those two countries highly suspect, but Poland’s experience with shock therapy has hardly been enviable. Were the sharp declines in GDP (12 percent in 1990 and 7 percent in 1991, according to standard estimates) and industrial output (22 percent in 1990 and 15 percent in 1991) inevitable results of economic reform, or rather the unnecessary effects of an inadequate reform approach? Poland’s economy improved in 1992 and 1993, with a GDP increase of 1 percent in 1992 and 4 percent in 1993. The road back from the economic damage inflicted by shock therapy is thus long, even when a country is characterized by an “intense desire to rejoin the economies of Western Europe,” as Lipton and Sachs described the situation in Poland in 1990.

Andrew Berg and Sachs counter by arguing that “the overall decline in 1990 GDP was much smaller than the official estimate.” They contend that output was mismeasured and that consumption declines were modest. Shock therapy’s defenders like to suggest that salaries were widely underreported because of “the vast black economy,” and to highlight the rapid rise in the purchase of big-ticket items such as automobiles in Poland. But these

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176Lipton and Sachs, “Creating a Market Economy in Eastern Europe: The Case of Poland,” 76.


179Poland Survey,” The Economist 331 (16 April 1994), after p. 60 (insert p. 8).
factors do not mitigate the clearly negative effects of shock therapy for a large proportion of the Polish population. Following the introduction of the "big bang," private sector activity soared, but real incomes dropped much more sharply than had been expected.\(^{180}\)

If, as shock therapy proponents want to suggest, the economic picture was bright in 1992 and 1993, why were reform candidates being defeated at the polls? In September 1993, the electorate voted into office a parliament dominated by former communists and a communist-inspired agrarian party. These candidates had campaigned on a promise to soften the harsh effects of economic reform, while continuing to move the country toward a market economy. A nation whose citizenry were, in general, enjoying the fruits of newly realized economic prosperity--from new cars to thriving black market businesses--should hardly have been expected to banish the goose that was bringing them such golden benefits.

Consistent with these voting patterns, a public opinion study reported in April 1994 by Bronislav Geremek, chair of the Committee on International Relations, found that only 20 percent of respondents in Poland continued to support the reforms.\(^{181}\) This was in sharp contrast to survey results in 1989 which found 70 percent in favor of economic reform.\(^{182}\) And Poland’s political situation remained tense and unpredictable in 1994. As President Lech Walesa’s popularity continued to slide,\(^{183}\) in April disagreements with the Polish parliament prompted Walesa to threaten its dissolution.\(^{184}\)

Further, as Poznanski points out, successes that have been enjoyed in Poland’s economic course since 1990 are attributable, “in large part, to the fact that many shock therapy policies have been softened, if not reversed.”\(^{185}\) The bottom line is that, in Poland, "Western approach" proponents do not have a good example to support their position.

With such a disappointing reform record as Poland’s for the "Western approach," it would be prudent for reform planners to search wherever they can to identify promising leads.

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\(^{181}\) Aleksei Pushkov, "Chudes i paradoksy pol’skich reform," Moskovskie novosti, no. 15 (10-17 April 1994), A13. The study found that another 20 percent opposed the reforms and the majority (60 percent) were either uncertain or "politically passive."

\(^{182}\) Ibid.


that might lead to improvement over this undistinguished example of neo-liberal initiatives. In this context, China's experiences should be mined for information of possible value rather than reflexively rejected as largely irrelevant to other settings. China shows that it is more than theoretically possible to promote market development without wreaking havoc on an economy in the process. But even in 1994, Sachs was still attempting to characterize the debate in Russia over "the relative merits of shock therapy versus gradualism" as, in reality, a choice between "a sensible and consistent financial policy" (his, of course) and a more gradual approach that was being proposed "by a bitter and corrupt Communist opposition." \(^{186}\)

Other research has reached very different conclusions from Sachs and Woo's about the potential value of the Chinese example in informing economic reforms elsewhere. Jefferson and Rawski, for example, recognize that "China's industrial gains of the past 15 years are partly attributable to favorable initial conditions. But," they continue, "the contrast between China's trend of buoyant increases in industrial output, real wages, employment, and exports and the performance of industry in states that have attempted to accelerate the pace of institutional change is too large to be explained solely by differences in initial conditions." \(^{187}\)

Naughton observes that although "some features of the Chinese experience" have been "intriguingly positive," while some have been "clearly negative," the literature of economic reform includes only "a few diffuse characterizations of the Chinese process" which are circulated "without much critical reflection." \(^{188}\) An important reason for this situation, of course, is the power of incompatible paradigms over the minds of analysts who are committed to a particular one. As Thomas Kuhn points out, "the proponents of competing paradigms practice their trade in different worlds," and "Practicing in different worlds, the two groups of scientists see different things when they look from the same points in the same direction." \(^{189}\)

"Unfortunately," Sachs insists, "there is little in China's experience that is directly applicable" to the Russian case. \(^{190}\) But until now, we find scant evidence that "Western approach" proponents have earnestly tried to assess whether or not Naughton is correct that the economic changes taking place in China "form a virtuous cycle of reform" \(^{191}\) which suggests that "there are specific characteristics of the centrally planned system that can be used to

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\(^{186}\)Sachs, "Betrayal," 18.

\(^{190}\)Naughton, "What is Distinctive about China's Economic Transition?" 472.
initiate a step-by-step reform process," and that "once a crack is opened in the monolith that is the centrally planned economy, cumulative forces take over and prize the crack open ever more widely."192

This is the antithesis of Sachs and Åslund's position. "The examples of harm caused by gradualism in the transition are ample," Åslund contends--without furnishing any satisfactory proof of his statement.193 Indeed, when "Western approach" proponents attempt to provide examples in support of this position, the examples are, in all cases we have found, actually evidence against it. Åslund argued in 1992, for example, that "gradual deregulation gives economic crime an unnecessary and very dangerous boost."194 The unfolding of events in Russia suggests that the opposite has been true there. Russia's hurry-up privatization scheme, so warmly praised by these analysts, is deeply implicated in Russia's epidemic of organized crime, as we have pointed out in an earlier report.195 And Sachs's contention that an evolutionary approach would allow "rear-guard actions by old power structures" to "succeed in derailing key reforms"196 is equally unsupported by results of the actual course of reforms in Russia. Contrary to Sachs's claim, it was the haste of reforms, particularly, that opened the door to nomenklatura profiteering from privatization and the consolidation of power by the old Soviet bureaucracy in the wake of the rapid destruction of prevailing linkages in the political and economic systems.

"There is no guarantee," economist Joseph Brada contends, that the evolutionary approach, which requires the long-run co-existence of a large Soviet-type system with a small, nascent and fragile capitalist system in a single economy will eventually result in a triumph of capitalism over socialism. Indeed, just the opposite is to be expected, as the economically and politically powerful state sector will act to marginalize or wipe out small capitalists."197 But contrary to Brada's expectation, the private sector is flourishing in China. In Russia, on the other hand, after the failed attempt at shock therapy, entrepreneurs are struggling to regain the toe-hold that seemed firm before the "Western approach" intervened.

193Åslund, "The Gradual Nature of Economic Change in Russia," 34.
Sachs and Woo continue their argument by maintaining that "China's two-track liberalization facilitated the flow of peasant agricultural workers to new sectors. . . . Subsistence agricultural workers are delighted to move, since the wages in the new sector are higher than in subsistence agriculture." But EEFSU "State-sector workers, however, may prefer to remain in the state enterprises even though their productivity would be higher in the new firms." They offer no empirical evidence, however to support this critical hypothesis. Their logic is that "As long as the subsidy to state-enterprise workers is greater than the difference in productivity in the two sectors, state workers will not voluntarily leave their jobs for the non-state sector." Their entirely-hypothetical reasoning on this point cannot obscure the obvious attraction of nonstate business in both Russia and Poland, as well as in China, when real entrepreneurship is allowed to develop. Not only do Sachs and Woo fail to present a persuasive hypothetical argument here, but they also neglect to consider a number of ways that private sector development could be, and has been, encouraged by reformist governments.

The only ways Sachs and Woo can think of to "dislodge" state workers from their subsidized jobs are to cut state enterprise subsidies ("the 'big bang'"), to introduce private sector subsidies, or to privatize existing state enterprises. "in order to raise their productivity directly." Lacking data to support this position, the authors refer readers to "a simple formal model" in an appendix "to make the point." And they use their appendix "model" to also "prove" that "small reforms simply produce a political backlash," because "partial reforms lead to insufficient sectoral readjustment compared to what the "big bang" would produce."

Sachs and Woo's appendix presents a hypothetical situation in which workers are asked "to vote on a proposal to eliminate subsidies completely." But the features of their hypothetical situation are hardly illustrative of any real-world situation to be found in Russia. We wonder, to mention just one example, why they think that Russian workers would be asked to vote on such a proposal. We have not found, outside such remote appended narratives, any suggestion among followers of the "Western approach" that Russia should move to a system of direct democracy. Their inclinations have, instead, been notably in the opposite direction.

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199 Ibid., 6.
200 Ibid., 7.
201 Ibid., 39.
Unlike the situation in China, Sachs and Woo insist, market reform in the EEFSU necessarily involves a decline of industry "because of the excessive size of heavy industry in the EEFSU, and the corresponding underdevelopment of the service sector." Of course that is true, but the statement does not speak to the real question here. Would the decline be greater with an evolutionary approach than with "big bang"? They do not say. The principal theme of this paper has been, however, that the evidence is compelling that an evolutionary approach has a decidedly better chance than the "big bang" of minimizing productivity declines.

"Economic planning was far more deeply entrenched in the EEFSU than in China," Sachs and Woo note, and "the specificity of state planning was far greater in the EEFSU." Further, "regional governments were given greater autonomy in China than in the EEFSU." Again, this is an argument for a more thoughtful and studied approach in the EEFSU, rather than for overnight attempts at liberalization and hurry-up plans for privatization. These analysts offer no evidence to suggest why they propose a different interpretation of these historical and structural differences.

But because of gradual decay in economic performance during the 1980s, Sachs and Woo observe, a policy of "decapitalization" was followed in the EEFSU, in which "the physical and financial capital stock was simply allowed to run down." To sustain consumption levels, in all of these countries an extreme foreign debt crisis developed. But contrary to their reasoning, this would seem to be an argument for the smoothest possible transition, which would be oriented toward minimizing productivity declines and the kind of political instability that would deter massive foreign investment. The Russian government's attempt to follow the "Western approach" had the opposite effects.

"On almost all fronts." Sachs and Woo maintain, "the state-enterprise sector in China has continued to perform poorly. It is heavily loss making." In citing "several recent studies of the Chinese experience," Sachs and Woo make a major point of emphasizing the relatively lower level of performance of state-owned enterprises (SOEs) compared to those in the non-state sector, while ignoring two other critical factors. First, China's two-track program is intended to reduce the state share's contribution to industrial output, and it has. Naughton reports that "the SOE share of industrial output declined from 78 percent of the total in 1978 to 48 percent in 1992, the first year in which SOEs did not produce the majority of industrial

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201Ibid., 4.
202Ibid., 11.
204Ibid., 18.

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output." Further, SOE output grew 7.7 percent annually between 1978 and 1991.\textsuperscript{206} That is, state enterprise output has increased impressively during the period of Chinese reforms. We will not recount the dismal record of Russian industrial output since the Gaidar reforms began there. Naughton provides a decisive refutation of Sachs and Woo's attempt to make a point about SOE performance in China: "That Chinese SOEs, despite their numerous failings, were able to support a transitional process without serious disruption is significant."\textsuperscript{207}

"The real question," Sachs and Woo ask, is "why gradualism failed" in the EEFSU countries.\textsuperscript{208} We will briefly address that question for Russia. The short, but not inaccurate, answer is that gradualism failed there because Yeltsin's multi-pronged attack on the Soviet Union and Gorbachev's reforms thwarted it. From 1989 until late 1991, Gorbachev made a great deal more progress in transforming the political system of the USSR toward democracy than the Yeltsin government has made from 1991 onward. Democratic development under Yeltsin has been derailed. Gorbachev had realized stunning success in making legislative institutions more democratic and removing monopoly power from a small cadre of elites. Yeltsin has reversed this process, and his recent actions to consolidate executive power have restored defining characteristics of the pre-reform Soviet system.

But Western advisers to the Russian government have been conspicuously ambiguous about their position regarding democratic processes in their writings. In discussing the political context of reforms, Lipton and Sachs argue that, under conditions where "a fragile democratic opening" was combined with severe economic crisis, "Only decisive actions by a reformist government can keep . . . populist pressures in check."\textsuperscript{209} It is noteworthy that they offer no recommendations, however, about how to mesh democratic processes with "decisive" government actions. Indeed, Sachs's endorsement of the Yeltsin constitution would be as heartening to Zhirinovski, who was one of the most fervent campaigners for the document, as to Yeltsin. Sachs is correct that "The adoption of the new constitution in December 1993 is a clear and significant factor that tends to strengthen the political capacity of the central government."\textsuperscript{210} But what he fails to address is the question of the central government's new "capacity" for what? Zhirinovski's answer to this question is more transparent than Yeltsin's.

\textsuperscript{206}Naughton, "What is Distinctive about China's Economic Transition?" 476.
\textsuperscript{207}Ibid.
\textsuperscript{209}Lipton and Sachs, "Creating a Market Economy in Eastern Europe: The Case of Poland," 87.
\textsuperscript{210}Sachs, "Russia's Struggle with Stabilization," 32.
Indeed, democratic governance turns out to be a low priority among "Western approach" advocates, although this deemphasis is often masked with rhetoric. Former adviser to the Russian government Anders Åslund, for example, repeatedly writes about the importance of democracy in the transition, but it is not clear what he means by the term. On the one hand, he insists that "the slower democratization has been, the costlier the economic transition," but on the other his perspective about what is required for democratic processes to operate is left vague, at best. He argues, for example, that severe shock therapy measures should be "adopted as a big package," because "Greater speed implies less time for discussion." Such a scheme is not what we would call democratic, but it is consistent with Åslund's assessment of the structure of the United States government, which he presented in another work: "In many ways, Moscow politics are reminiscent of Washington. A complex system of internally divided bodies are supposed to make decisions. The result is a variety of surprising coalitions, while most decisions are much delayed," Åslund complains. It is true, of course, that the US is not Pinochet's Chile.

And in the economic arena, impressive privatization figures since the Gaidar reforms began mask ruinous chaos stemming out of the liberalization and privatization schemes advocated by Western advisers. The small but thriving entrepreneurial class that had emerged under Gorbachev has been muzzled under Yeltsin, at the same time that organized crime has penetrated deeply into all aspects of both private and state business. What was proclaimed as a program to free the invisible hand of the market has become a program whose most important achievements have arguably been to unshackle the all-too-visible fist of the mafia and the long-familiar reach of the state bureaucracy.

Sachs and Woo are correct that serious mistakes were made under Gorbachev. Prime Minister Valentin Pavlov's declaration in January 1991 that 50-ruble and 100-ruble bills would no longer be legal tender, for example, was a wrongheaded move. But the consequences of that foolish action cannot be compared in magnitude and injurious scope to the price liberalization policy enacted by Gaidar a year later, at the urging of Sachs and his associates.

[211] Ibid.
Gradualism failed in the Soviet Union because it was stopped in its tracks, and reformers with a radical vision were central agents of its demise, as we have pointed out elsewhere.\textsuperscript{214} The Union economy was purposefully undermined by Russian leadership through the deliberate withholding of taxes, and other measures, and Union authority was challenged by Yeltsin and other Russian leaders through a variety of clearly provocative actions. In Yeltsin, Russia got a champion of radical reform who was the darling of Western monetarists; and in the Russian ministries which took over the functions of their Union counterparts, Russia got a number of people who were inexperienced at the job of running a country.

Several "Western approach" proponents had voiced strong displeasure with Gorbachev's gradual, and often halting, approach to reform before the Soviet Union's demise.\textsuperscript{215} It began similarly in China, also. Woo recognizes this fact but inexplicably considers this to be evidence against the appropriateness of an evolutionary approach to reform. In a 1994 paper, Woo points out that "Gradualism in China is the result of the political deadlock between the Stalinists and the reformers, and not the result of a particular theory of reform."\textsuperscript{216} This is not unlike the political situation in the Soviet Union in the late 1980s, when opposition to Gorbachev's initiatives frequently caused reversals in the momentum of change and prevented the systematic promulgation of a coherent reform strategy.

"There is no theory behind Chinese gradualism," Woo objects. Thus Woo follows his monetarist colleagues in failing to appreciate the practical value of not being bound by the dictates of a rigid theory, when the question is how to transform a specific economy in a particular period of its development. This "no theory" option has led China, from 1978 to 1994 to a place in which China's macroeconomic performance rivals that of Japan and Korea.\textsuperscript{217} China's transformation was not guided by overarching theory of what should be done when, certainly, and that has been it strength. Rather than being guided by a prefabricated theory, Chinese reforms have been realized according to a clearly identifiable perspective about process--"a step at a time," as Shahid Yusuf, research administrator at The World Bank, characterizes the Chinese way. By "always ensuring that each economic initiative


\textsuperscript{216}Wing Thye Woo, "The Art of Reforming Centrally Planned Economies: Comparing China, Poland, and Russia," Journal of Comparative Economics 18 (June 1994), 279.

\textsuperscript{217}See, for example, Shahid Yusuf, "China’s Macroeconomic Performance and Management During Transition," Journal of Economic Perspectives 8 (Spring 1994), 71.
passed the test of socio-political acceptability before it was widely implemented. China has maintained the momentum of change while minimizing the risk of instability.\textsuperscript{218}

The choice between the evolutionary and the shock therapy approach is not a choice between two competing theoretical templates, each with its own set of inflexible forms, but rather a choice between a rigid formula, with overriding emphasis on speed, on the one hand, and a preferred process on the other--one which involves, at its heart, coalition-building, compromise and reassessment. It has often been characteristic of Russian reform plans, including Yavlinskii and Shatalin's "500 Days" program, for predictions to be made with too much confidence that particular "stages" of reform could be reached in predetermined time periods. But we see in the "500 Days" program, and also in the subsequent proposal outlined by Allison and Yavlinskii,\textsuperscript{219} recognition that reform planning and implementation are dynamic processes, which necessarily involve active response to initiatives that are introduced and openness to modification as demanded by circumstances. This orientation is not a part of the "Western approach." It is arguable that deep-seated cultural factors may be implicated in China's choice of gradualism and Yeltsin's preference for a "big bang" approach. This would not explain, however, the decision of Western advisers and financial institutions to push Russia in the "big bang" direction.

Woo argues, rightly, that "gradualism is not like a person putting on his pants one leg at a time," because "the main reason behind gradualism is absence of social consensus over what the final state of affairs should be."\textsuperscript{220} It is clear that the situation under Gorbachev was similar. If the "500 Days" program suggests the crystallization of a plan, its failure to win approval underscores the absence of social consensus in the economic sphere.

And Woo believes that the strength of "big bang" is that, in contrast to gradualism, it "means a person who, while putting in his first leg, cannot wait to put in his second one."\textsuperscript{221} Unfortunately, the evidence suggests, with Sachs and Woo's "big bang" approach, in his haste to get the job completed, the person all too often pulls his pants on over his head.

Concluding Remarks

The case is compelling that only dysfunctional theoretical blinders can inure reform planners to the overwhelming advantage of tailoring reform programs to a country's economic, political and cultural circumstances. Of course, differences between China and Russia on a

\textsuperscript{218}Ibid.
\textsuperscript{219}The "Window of Opportunity" proposal.
\textsuperscript{220}Woo, "The Art of Reforming Centrally Planned Economies." 281.
\textsuperscript{221}Ibid.
large number of dimensions would necessitate, from an evolutionary perspective, that reform programs for the two countries should also be different in many ways. But monetarists' continuing emphasis on the factors which set Russia and China apart—characteristics which, unquestionably, would demand strategic divergences as well—indicates that they have failed to come to terms with the real issues that distinguish their approach from an evolutionary alternative—questions about flexibility, institution building, and the relative merits of cooptation and coalition building.

After several attempts at reform through shock therapy, proponents of this approach cannot claim a single success in maintaining an orthodox shock therapy program while nourishing democratic processes at the same time. Was Gorbachev's fall from power, and an end to the country's search for its own path to the market, inevitable? We believe it was not, but that is not the subject of this report. Further, gradualism under Gorbachev demonstrates that Chinese authoritarianism, on the one hand, and Yeltsin and Pinochet authoritarianism, on the other, are not necessary components of an evolutionary approach to economic reform.

Lipton, writing about the course of Russian reform, complains that, after Gaidar "started Russia swiftly down the [monetarist] road at the beginning of 1992 . . . , an intense political backlash began almost immediately: In six months." Lipton laments, "the reform effort was hamstrung by its opponents." This course of events should have come as no surprise to Lipton. The Eastern European and Russian experiences with shock therapy illustrate why, as students of politics have long known, that there is no good substitute for open deliberation and political coalition building without dictatorship.

In his foreword to Sachs's 1993 work *Poland's Jump to the Market Economy*, another former adviser to the Russian government, Richard Layard, notes that Jeffrey Sachs had already decided by 1989 that "action should be as rapid as possible on all fronts" in reforming post-Soviet economies. "Since then," Layard continues, "he has applied his strong mind and tenacious powers of persuasion to developing appropriate plans of action in one country after another, as it abandoned communism. Rarely does an academic economist have such an immediate effect on world events."

Layard's interpretation of the Western advisers' influence is supported by our research. Sachs's "tenacious powers of persuasion" succeeded in giving his shock therapy approach an...
extraordinary opportunity for implementation in the post-communist world. But this chance was, of course, a two-edged sword.

Ongoing inquiry into economic policymaking under conditions of massive societal change is benefiting immeasurably from data now pouring in about the course and implications of reforms in Russia and Eastern Europe. Several of these countries, which for decades sought to realize the Marxist vision of an economic utopia, understandably responded to the demise of the command system by reflexively embracing Marxism’s economic antithesis, when they acquired a measure of political freedom not yet enjoyed in China. But the monetarists’ unsound script for economic transformation has plainly demonstrated its inadequacy in the post-communist world’s protracted twentieth century economic and political drama.

Unfortunately, the monetarists’ project in Russia has damaged a great deal more than the credibility of the "Western approach." Democratic institution building has suffered a crippling setback, as has the credibility of market reforms among a substantial proportion of the population. Russia’s cultural and scientific spheres have been put at grave risk, as the economic life blood of Russia has been drained rapidly, with no infusion of growth in sight. In July 1994, Russia’s GDP was still tumbling (down 17 percent in the first half of 1994225), production still declining precipitously (down 29 percent from a year earlier), and consumer prices still soaring (up 412 percent the previous year). Short-term interest rates were pegged at 392 percent.226 At that time, the research arm of The Economist was predicting that, whereas China’s economy was expected to grow 10 percent in 1994 and 6.5 percent in 1995, the Russian economy would decline 8 percent in 1994 and another 3 percent in 1995.227 As the pall of authoritarianism at the federal level continued to intensify in mid-1994, along with disorder brought on by institutional fragmentation at the level of ministries and enterprises which was not effectively prepared for, there were few signs that Russia might soon recover from the aftereffects of the grim shock therapy experiment which was launched vigorously at the beginning of 1992.

As we have shown in this report and elsewhere, Russia’s Western advisers applauded the beginning of the Russian shock therapy initiative unambiguously—even several months following its onset. On this point Sachs is unequivocal. "Dramatically," Sachs argued a year after Russia’s economic program was initiated by Gaidar. "the first post-communist government of Boris Yeltsin in Russia launched a massive program of ‘economic shock

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227Ibid.
therapy' at the start of 1992 clearly informed by the Polish experience. I have had the high honor of advising the Russian government on that program since its inception," Sachs continued. "After three years of Poland's reforms and one year of Russia's reforms. I remain absolutely convinced in the potential for successful economic reforms throughout the region." 228

By 1994 Sachs wanted to retract his earlier ringing endorsement ("Contrary to recent commentary, 'shock therapy' did not fail in Russia. It was never tried," he was saying now.229) Such disclaimers are as misleading as they are predictable. Kuhn illuminates the dynamics that are at work here, as closely-held paradigms are displaced by the unavoidable light of empirical evidence. Resistance to alternative perspectives, Kuhn reasons, is to be expected--"particularly from those whose productive careers have committed them to an older tradition of normal science." And he continues. "The source of resistance is the assurance that the older paradigm will ultimately solve all its problems. that nature can be shoved into the box the paradigm provides." 230 Such are the signs, Kuhn notes, of revolutionary paradigm shift. 231

It is not "recent commentary" at all, of course, that Sachs is taking issue with in his 1994 reappraisal, but rather his own words, penned as shock therapy's early impact was still being felt--and before political forces in Russia began to use their leverage to change the program. In arguing, now, that their theoretical program was not tried in its pure form, the monetarists are in good company with diehard Marxists, and for similar reasons. The shock therapy approach that was urged on Russia by Western advisers wrongly assumed that interest groups could be coopted into conforming with the program's dictates, as we have shown in earlier reports. And this was a necessary assumption of the shock therapy scheme, in the planners' view, because they believed that open deliberation would have led to compromise. In that they were correct, of course. That is the stuff of democratic processes. And it has repeatedly been found that open review and deliberation can produce programs that are superior to those that are hammered out in isolation by planners too-far removed from the institutions they want to change. What the Gaidar team refused to accept was that political and social constraints and preexisting economic conditions are more immutable than reform strategies, and that they are more appropriately highlighted to inform policymaking at the

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228 Sachs, preface to Poland's Jump to the Market Economy, xii-xiii.
229 Sachs, "Betrayal." Emphasis added.
230 Kuhn, The Structure of Scientific Revolutions, 150-51.
231 Ibid., 149-52.
beginning of reforms than to retrospectively excuse transition formulas that are served up, cafeteria-style, to all who can be persuaded to fall into line.

What Russia got, after the monetarist experiment had run its course, was a substantial measure of the worst features of both China's evolutionary path and the Western advisers' shock therapy prescription. The "shock" component in Russia--which was broader and deeper than had been promised--triggered a political reaction which was met by the Yeltsin circle with authoritarian rule. Thus armed with unchecked power, Russia's executives used the reform structure newly in place to enlarge their domains of control--with no people's soviets, and no party system, to temper their personal ambitions--and no strong commitment to therapy for the people. Now, Russia is well along the road toward losing entirely the democratic structures China never had, but Russian leaders, rather than using their authority to achieve citizen-oriented reforms, are characteristically pursuing unrestrained self-aggrandizement and further consolidation of power. And Western leaders look on helplessly, unable to disavow gracefully the untoward mutation that has developed as they watched, and applauded.

If there is a silver lining in Russia's clouded future, it is that the striking failure of the "Western approach" on both economic and political fronts may signal the final burial of the monetarists' transition strategy and facilitate a clearing of the stage for more thoughtful development of economic policies--ones that mesh better with economic and political realities. Our optimism is muted, however, by the insuperable fact that the political environment for economic reform in Russia has now been changed decisively and intractably for the worse.