

Russian transition to capitalism: what would have made it less painful?

[Government](#), [Capitalism](#)



RUSSIAN TRANSITION TO CAPITALISM: WHAT WOULD HAVE MADE IT LESS PAINFUL? CONTENTS 1. INTRODUCTION 2. POLITICAL & ECONOMIC & SOCIAL ISSUES OF POST SOVIET RUSSIA ☞ SOCIAL WELFARE ☞ HEALTH CARE ☞ EDUCATION SYSTEM ☞ TAX COLLECTION 3. TRANSITION CHALLENGES: FROM PLANNED ECONOMY TO THE MARKET ECONOMY SYSTEM ☞ TERMS AND CONDITIONS OF THE TRANSITION TO THE MARKET ECONOMY ☞ PRIVATISATION ☞ LIBERALIZATION ☞ MONETARY AND FISCAL POLICY 4. KEY ECONOMIC MISTAKES 5. CONCLUSION 6. APPENDIX 7. BIBLIOGRAPHY 1.

INTRODUCTION The Russian economy experienced tremendous stress as it moved from a centrally planned economy to a free market system. In this paper we will describe the challenges Russia faced during the transition period. The challenges consisted of political battles, a series of economic and social crises, and the poor results that came with many of the reform efforts. Russia was experiencing three revolutions all at once. First, they were attempting to fashion a new democratic political system (and truly needed to replace the old Communist-era constitution). Second, they were trying to launch a new capitalist economy. And finally, they were coping with its postimperial status: within a few short years, Russia had lost the Cold War and its superpower position in the world, had given up its influence over Central Europe and neighboring republics that had been part its empire since the 1920s. In the main section of the paper I will identify key economic mistakes of the Russian reform processes as they moved toward market economy. I will also incorporate the key factors that many Western economists described as being essential for the successfully functioning of the market economy. These factors included privatization, liberalization and

monetary and fiscal policy. I will then look at the major mistakes made by the Russian government during the transition process. In conclusion, I will present my opinions as to the most important factors which would have made Russia's transition smoother and less painful.

2. POLITICAL & ECONOMIC & SOCIAL ISSUES OF POST SOVIET RUSSIA

The breakup of the Soviet Union in 1991, along with independence brought a lot of issues to Russia and the other fourteen republics, none of which had any experience in self-governance. All the nations were starting from a situation where there was political and economic crisis and some had total social chaos. For Russia, the end of the Soviet Union meant facing the world without the considerable safeguard zone that the Soviet republics that had provided it in various ways since the 1920s; and the change also required complete reorganization of what had become a totally corrupt and ineffectual socialist system. The colossal changes in Russia and all post-Soviet Union countries really started with President Gorbachev's "perestroika and glasnost" (rebuilding, publicity/ openness) policy. In August 1991 there had been an unsuccessful coup or "putsch" organized by old regime representatives, who tried to return previous administrative command system to power. One month after a failed coup all the key republics, including Russia, voted for independence. In December 1991 Gorbachev announced that the U. S. S. R. as a nation would cease to exist. In place of the monolithic union, there still remained the Commonwealth of Independent States (CIS) which was a loose confederation of eleven of the former Soviet republics which now were independent states with an indefinite mandate of joint cooperation. Boris N. Yeltsin, who had been elected president of the Russian Republic in June

1991, had become the leader of the new Russian Federation. Russians hoped that Russia could make a short, painless transformation to democratic rule and free-market economy. Although events of the first five post-Soviet years provided some reasons for optimism, most observers soon realized that whatever transformation Russia was to experience would require much more time to be completed, and would yield much less predictable results than many had initially expected. At the time of independence, the Russian Federation included nineteen autonomous republics, ten autonomous regions, and one autonomous oblast; each designated for a particular ethnic group. Throughout the 1990s, the state's social welfare system retained the bureaucratic complexities of the Soviet era, but it did not keep pace with the needs of society. The "social umbrella" of the Soviet Union's socialist system, which nominally had guaranteed to all citizens employment, health care, child care, pensions, and universal, high-quality education, also encountered problems • Russia's health care system deteriorated substantially in the 1990s. Equipment and medicines were in increasingly short supply, old facilities were not replaced, and existing facilities became inaccessible. Medical personnel generally are not trained as rigorously as their contemporaries in the West, and constant failures to pay doctors and nurses worsened shortages in those professions. The 1997 national budget allocated US\$1.6 billion for health, an increase of US\$158 million over 1996, but most of the new money was targeted for medical centers in large cities. The 1997 figure was 2.6 % of the gross domestic product (GDP), compared with the World Health Organization's recommended minimum share of 5 %. • Pensions. Reforms such as pension indexation and differentiation of

individual contributions to pension funds were only beginning to appear in the mid-1990s. By that time, the government's inability to collect taxes and other obligated funds had had a major negative impact on social programs. By the fall of 1996, an estimated US\$3 billion in pension payments were overdue. As rampant inflation devalued the fixed payments of the pension system, many older citizens depending on fixed incomes fell below the official poverty line (see appendix, Table 1). • Russia's education system suffered from the same shortages and lack of support as its health system. And education, which had been accorded high value in Soviet society, lost some of its as many traditional institutions are viewed with unprecedented skepticism. Teachers, who had always been underpaid in the Soviet system, became increasingly unmotivated in the new system and many have left the profession. Things were even more difficult since most of the Soviet-trained Russian educators did not understand individual initiative and self-sufficiency and had difficulty coping with the changes. • Tax collection remained a major problem for Russia until early 1997. Although some nominal tax reforms were put in place, tax collection remained ineffectual, and the system still failed to promote private initiative or foreign investment. For the majority of Russian citizens, the economic reforms of the 1990s did not improve the quality of life; indeed, in 1996 the " shock therapy" of Russia's transition to a free-enterprise system increased level of poverty as unemployment figures rose. Russia's society has become increasingly divided according to economic categories. (see Appendix Table 1, Table 2) . Another obstacle to economic stability was the pervasive influence on economic activity of the mafia--as commonly used in Russia, a term

including gangsters, dishonest businesspeople, and corrupt officials. As the majority of Russian citizens struggled to remain above the poverty line, a small minority prospered through high-risk economic ventures that often involve connections with the mafia, Russia's persistent network of organized criminal organizations. Moreover, there were former members of the Soviet official elite, the "nomenklatura", who have used Soviet-era connections to gain access to financial resources and influential enterprise positions in the new system. Older Russians and all older Soviet people in all the Republics found adapting to the complexities and challenges of post-Soviet society much more difficult than younger generation. Many of the former group often tried to preserve as much as possible of their former lives and saw in their minds a nostalgic view of an idealized Soviet past.

3. TRANSITION

CHALLENGES: FROM PLANNED ECONOMY TO THE MARKET ECONOMY SYSTEM

☞ TERMS AND CONDITIONS NECESSARY FOR A TRANSITION TO THE MARKET

ECONOMY In the market economy, the market works as a major adjustment mechanism between production and consumption, or between demand and supply. At least following conditions required for establishment of the market

economy: 1. Free competition- free competition required for the market to adjust production to consumption, at the same time freedom of participation in the market must be guaranteed 2. Limited government role- government must take a "watchmen" position, establishing rules and guaranteeing compliance with the rules. The government is also required to fulfill other functions including covering market failures, establishing social security and promoting social development. Effective taxation system should be established by government as well. 3. Decentralized process of decision

making- enterprise businesses must have economic rights to make an independent business decisions in trading, providing services and making capital transactions. 4. Developed legitimate system of economic – In order to have a strong functioning market economy government has to issue and implement effective legitimate foundation covering all subjects of market economy. In a planned socialist Russian economy, economic decision making powers had substantially concentrated in government, which regulated economy by directing other economic units to implement plans and meet benchmarks. There was no place for free transactions and free competition. The banking system and all capital markets were under state control. In addition, the government of transition economy must create market economy institutions and market infrastructure to guide the economy through the challenges:

- Privatization of state enterprises
- Liberalization of domestic and foreign trade
- Free competition establishment
- Creation a banking system , including of National (Central) Bank and commercial banks
- Establishment of tax and state finance system
- Implementing enterprise law and creating legislative institutions for effective functioning of market economy.

The most important issue for the government of transition economy must deal with is the need to maintain secure and lawfull business environment to allow enterprises to engage in free competition and make profit .

☛ **LIBERALIZATION** Liberalization is another of the important policies for transition to a market economy. Liberalization means the elimination of administrative regulations on choices of sellers and buyers. Depending on objective conditions, liberalization requires government intervention. The programs of liberalization and stabilization were designed by Russian

president's deputy prime minister Yegor Gaidar, a young liberal economist inclined toward radical reform, and widely known as an advocate of "shock therapy" (the sudden release of price and currency controls, withdrawal of state subsidies, and immediate trade liberalization within a country). "Shock therapy" began days after the dissolution of the Soviet Union, when on January 2, 1992; Russian President Boris Yeltsin ordered the liberalization of foreign trade, prices, and currency. After that million Russians took to the streets to buy and sell goods. Many of the streets of Russian towns became an unorganized marketplace. The immediate results of liberalization, that is, lifting price controls, created conditions that lead to hyperinflation and the near bankruptcy of much of Russian industry. Liberalization definitely had an important role in transition period for Russia, but government should not have only eliminated and relaxed the strict regulations established during planned economy, they also should have developed subjective and objective conditions that would have allowed economic units to function in a secure economic environment and make an independent business decisions. 🚗

PRIVATISATION A market economy cannot work in a country where most of enterprises are nationalized. Privatization means the transfer of enterprises from the public to the private sector. The role of government in privatization is to develop a business environment encouraging enterprise owners to manage their enterprises rationally, establish corporate and other laws providing for beneficial activities of privatized enterprises, and train enterprise owners as market economy actors. Russia adopted the so-called voucher method for privatization. Every citizen received a 10, 000 ruble voucher that could be used for making bids for enterprise ownership through

auctions to promote privatization. Russia introduced two variants of the preferential treatments for enterprise employees. The first variant gave employees preferred shares in equivalent of up to 25% of the enterprise's fixed capital on a of-free-of-charge basis and allowed them to buy up to 10% of total shares at 30% discount from face value with installment payments within 3 years. It also allowed managerial employees to purchase up to 5% of the fixed assets. The second variant allowed employees to purchase shares of common stock equivalent to up to 51% of the fixed capital before others were allowed to acquire shares. In privatization process, 75% of the enterprises chose the second variant. Furthermore, managers of each enterprise purchased vouchers and took advantage of all legal and illegal possible tools to put as many as shares possible under their control and avoid any control by outsiders. For example, managers of an enterprise used corporate funds to establish their own investment fund to purchase vouchers from employees and citizens, often taking advantage of the poverty of these people. As a result, there was little outsiders' real equity stakes in most Russian enterprises. ☞ MONETARY AND FISCAL POLICIES In 1992-1993 the Government expanded the money supply and credits at explosive rates that led directly to high inflation and to a depreciation of the Russian currency (ruble). In the second and third quarters of 1992 the money supply increased at especially sharp rates of 34 and 30% respectively and by the end of 1992 the Russian money supply increased by eighteen times since the transition began. The sharp increase in the money supply was influenced by large foreign currency deposits that state-run enterprises and individuals had built up as they were allowed to freely buy foreign currency and currency

obtained as foreigners wanted to invest in the "new economy," and also by the depreciation of the ruble. The government restricted lending to state enterprises after it lifted controls on prices, but enterprises faced cash shortages because the decontrol of prices cut demand for their products. To support continuing production under these circumstances, enterprises relied on loans from other enterprises. By mid 1992 when the amount of unpaid inter-enterprise loans had reached 3.2 trillion rubles (approx. \$20 billion USD), the government froze inter-enterprise debt. At that point the government provided 181 billion rubles (about 1.1 billion USD) in credits to enterprises that were still holding debt. The Russian government also failed to constrain its own expenditures in this period, partially under the influence of the conservative Supreme Soviet, which encouraged Soviet style of financing for favored industries. By the end of 1992 the Russian budget deficit was a little more than 20% of GDP. (see Appendix, Table 3). This budget deficit was financed largely by expanding the money supply as the central bank purchased government bonds. These monetary and fiscal policies were factor along with price liberalization in an inflation rate of over 2000% in 1992. (see Appendix, Table 4) Difficulties in implementing fiscal reforms aimed at raising government revenues and reducing the dependence on short-term borrowing to finance budget deficits led to a serious financial crisis in 1998. Lower prices for Russia's major exports (oil and minerals) coupled with a loss of investor confidence due to the Asian financial crisis exacerbated the financial problems. The result was a rapid decline in the value of the ruble, a flight of foreign investment, delayed payments on sovereign and private debts, a breakdown of commercial

transactions throughout the banking system, and the threat of runaway inflation.

4. KEY ECONOMIC MISTAKES Western economists suggested that several key economic mistakes that made Russian transition more complicated:

- The lack of organizational infrastructure for liberal market economy
- Unqualified management that was unable to implement sound corporate governance under the conditions of a new economy
- Lack of knowledge about market economy and private entrepreneurship/ownership
- Emphasis on privatization over competition
- Emphasis on restructuring existing enterprises over creation of new jobs and enterprises
- expected losses in "Bolshevik approach" reform
- Wrong strategy of privatization combined with capital market liberalization coupled with a failure to establish the necessary institutional infrastructure
- Excessive focus on macro-stabilization, not enough for growth

Besides these "economic mistakes" there were a lot of other obstacles which made Russian transition very painful:

- Weak legal framework and judiciary system which was unsuited for the successful functioning of market economy
- Political infighting, which brought political instability to the country and temporary chaos
- Difficulties of social adaptation (old generation had a hard time to accept the new rules of market economy and adjust it to a new lifestyle)
- Crime, which brought complexities to private enterprises and free entrepreneurship
- Corruption of government representative, which brought unfairness to the privatization process

5. CONCLUSION A foundation for market capitalism requires the dominance of private property, competitive enterprise sector, functioning markets, and respect for rules of market share. The market also needs a proper legal environment, one that is able to

support implementation of market rules, enforcement of contracts and correct behavior of economic representatives (households, organizations, and government). Throughout its years of transition Russia proved that the laws of market economics could also work in country set back by seventy years of socialist experiments and intellectual tradition of anti-capitalist attitudes, however, not speedily and only with much more complexities than anyone imagined. In my opinion, failure to anticipate these things and other points made above made the Russian transition more painful than necessary. In order to make that transition work more smoothly Russian policymakers and government should have prepared necessary foundations, like a "General Transition Plan" with detailed, step by step economic actions, taking into account not only economic effect but also social results of those actions, and making cautionary arrangements. The government also should have made creating a social safety as a priority during those reforms. This was most important for special social programs which would reduce a negative influence of the reforms on the less economically and socially protected citizens (like pensioners, people who are under government subsidies, people with disabilities, people with low income etc). As they reached the end of the transition process we can say that Russia has made some progress, but still had a long way to go in developing and strengthening the institutions necessary to regulate and support a market economy. This is most true as deals with protecting the rights of shareholders and property owners, to improve economic instruments and market infrastructure. Failure to do the necessary things made the transition more painful than necessary, but given the magnitude of what they were

trying to do, it is very difficult to see how it all could have been accomplished without a lot of pain.

6. APPENDIX TABLE1. POVERTY YEAR SUBSISTENCE

LEVEL AS DEFINED BY GOVERNMENT (RUBLES PER MONTH) AVERAGE

MONTHLY PENSION (% SUBSISTENCE LEVEL) POPULATION BELOW

SUBSISTENCE LEVEL (% OF TOTAL POPULATION) 1992 2 85 32 1993 21 100

31 1994 87 89 23 195 264 69 26 1996 370 80 21 1997 411 80 21 TABLE 2.

THE EMPLOYED AND UNEMPLOYED YEAR ECONOMICALLY ACTIVE EMPLOYED

UNEMPLOYED UNEMPLOYEMNT RATE (%) REGISTERED UNEMPLOYEMENT

RATE (%) 1992 75. 7 72. 1 3. 6 4. 8 0. 6 1993 74. 9 70. 9 4. 0 5. 3 1. 0 1994

73. 7 68. 5 5. 2 7. 1 1. 7 1995 72. 4 66. 4 6. 0 8. 3 2. 8 1996 72. 6 66. 0 6. 7

9. 1 3. 5 1997 72. 7 64. 8 7. 9 10. 9 3. 1 1998 (Q1) 72. 7 64. 4 8. 3 11. 4 2. 7

TABLE 3. BUDGET DEFICIT YEAR % of GDP 1992 21. 6 1993 7. 2 1994 10. 4

1995 5. 5 1996 8. 3 1997 7. 6 TABLE 4. INFLATION YEAR AVERAGE MONTHLY

RATE (%) ANNUAL RATE (%) 1992 31. 0 2509. 0 1993 20. 5 839. 9 1994 10. 0

215. 1 1995 7. 2 131. 3 1996 1. 7 21. 8 1997 0. 9 11. 0 7. BIBLIOGRAPHY 1.

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