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Russia: Political and Institutional Determinants of Economic Reforms

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1. Introduction

The purpose of this study is to analyze the course, determinants and political economy of economic reforms in Russia conducted in the period 1985-2003. The year 1985 can be considered an important turning point in Soviet/Russian history, marked as it was by the election of Mikhail Gorbachev to the position of General Secretary of the Communist Party of Soviet Union (CPSU) and (*de facto*) leader of the USSR. This nomination brought an end to two decades of political consolidation of the communist regime connected with the name of General Secretary Leonid Brezhnev and his short-living successors (Yurii Andropov and Konstantin Chernenko), often referred to ex post as 'the stagnation period' (*vremya zastoya*). Gorbachev initiated a series of important political and (to a lesser extent) economic reforms, which led eventually to the collapse of the communist regime and the disintegration of the Soviet empire in 1991. Thus, 1991 must be seen as another dramatic turning point in Russia's contemporary history. From the end of 1991 onwards political and economic reforms have been carried out by the new Russian state that emerged after the disintegration of the USSR.

This paper aims to explain the political and institutional determinants of economic reforms in the Russian Federation. It has been carried out under the Global Research Project on 'Understanding Reforms' organized and financed by the Global Development Network (GDN)[1] as one of 30 country studies covering a broad set of developing and transition economies. It presents the project's intermediate results and will be the subject of further discussion as well as analytical and editorial work in the near future.

The case of Russia is very important and interesting from the point of view of GRP 'Understanding Reforms' goals and agenda, for many reasons. **First**, all transitions from communist regimes and centrally-planned economies to democratic capitalism represent a much more complex, complicated and difficult reform experience than policy reforms observed in developing countries, especially when they relate to just one or a few specific policy areas. Thus, learning the transition experience, particularly in its early phase, can provide an

[1] For details concerning the 'Understanding Reforms" project see http://www.gdnet.org/activities/global_research_projects/understanding_reform/index.html

extremely valuable empirical input to 'understanding reform' and provide answers to the project's key questions: 'why reform?', 'what reform?', and 'how well did the reform perform?' (Fanelli and Popov, 2003; Schmidt-Hebbel, 2003).

Second, Russia had the longest and deepest experience of communism and the command economy. It was the first country to fall under communist rule and install a centrally-planned economic system (as a result of the October revolution in 1917 and subsequent Stalinist 'revolution' at the end of the 1920s and beginning of the 1930s) and lived under both for the next seventy years. Historically, Russia was the largest test ground for and greatest victim of Stalinist industrialization and collectivization of agriculture, with far-reaching economic, social and demographic consequences. In fact, the whole structure of the Russian real economy became heavily distorted in terms of sectoral/branch structure, giant size of enterprises, their often remote geographic locations, forced internal migrations, etc. Although many developing countries in the 20th century tried inward-oriented import substitution strategies (see Gaidar, 1997), none went so far in this kind of experiment as the former Soviet Union. These extreme structural distortions created an additional social and political burden, which heavily complicated the transition process.

Third, in contrast to other Central and Eastern European (CEE) nations (including the Baltic ones), Russian society has had no living memory of a market economy, democracy and civil society. Even before the Bolshevik revolution Russia represented a case of immature capitalism (compared to Western Europe or the US) and had almost no experience of a democratic system and rule of law. Thus, in the 1990s Russia had to build both a market economy and democracy virtually from scratch[2].

Fourth, the political economy of Russia's transition turned out to be extremely difficult. This was not only the consequence of the complicated structural, institutional and socio-cultural heritage (see above). The 'independence' factor, so powerful in many former communist countries (including some republics of the former USSR), was virtually non-existent in Russia. On the contrary, many ordinary Russians and a significant part of the political elite were upset by the loss of the Soviet empire (in its broader sense, including the former satellite countries of CEE) and attributed this unfortunate (in their minds) event to democratic and market reforms. As such, 'patriotism' in Russian politics came to be mostly closely associated with opposition to market-oriented reforms (resembling the experience of many developing countries) and weakened the support of Russian society to the reforms. This only slightly changed at the end of the 1990s when advocates of a strong Russian state began to understand that an efficient market economy is a basic precondition for achieving this goal.

Fifth, the dynamic of the reform process in Russia differed significantly from that of many

[2] Although lack of democratic traditions and institutions could also be observed in many developing countries entering the path of policy reforms (and, consequently, having to go through a 'dual' transition, both political and economic, similarly to post-communist countries) they did have experience with market mechanisms even if the latter had been distorted by excessive government interference.

other transition countries. While the pace and consistency of reforms through most of the 1990s was unsatisfactory, since 2000 one has been able to observe some acceleration in economic and institutional changes. Particularly interesting is that this reform acceleration has been underpinned by rapid output recovery and a substantial improvement in external economic conditions (high oil prices). At first glance, this would appear to contradict the key hypothesis that 'crises induce reform' and that politicians decide to change the status quo only when they do not see any other way out (see Fanelli and Popov, 2003; Fidrmuc and Noury, 2002; Ruis and van de Valle, 2003). However, in this particular case the reform acceleration of 2000-2002 can be linked back to a somewhat delayed lesson drawn by the political elite from the August 1998 financial crisis.

Sixth, the sequencing of Russia's reforms differed from those recommended by many experts and international financial institutions (IFIs) and from those experienced by the 'leading reformers' in Central Europe and the Baltic (CEB) region. In Russia, the mass privatization process was launched prior to macroeconomic stabilization and liberalization of domestic and external markets were completed. This means that a case study of Russia provides a way of understanding the roots of this sequential differentiation and its consequence for reform outcomes.

Seventh, due to strong historical and cultural links, political elites in many of the former Soviet republics have sought to follow the Russian experience in reforming both their economies and state institutions. It is, therefore, very difficult to understand fully the course of the economic and political transition in the CIS countries without a good understanding of what happened in Russia and why.

Eighth, the size and geopolitical importance of Russia would make any attempt to exclude it from a large-scale comparative analysis of the factors determining the course of successful/unsuccessful reforms very controversial.

Ninth, the same arguments, i.e. size of Russia, its military potential and geopolitical importance, underpinned the substantial engagement of the international community, particularly the G-7 governments and IFIs, in assisting Russia's transition process in the 1990s. However, the role and effectiveness of this support raised many controversies, both inside and outside Russia. This allows us to test empirically a hypothesis on the role of external factors in leveraging the reform process (see Schmidt-Hebbel, 2003).

In line with the project's overriding guidelines and assumptions we understand economic reforms to be changes in economic institutions and economic policies leading to an increase in the role of market mechanisms. In the case of post-communist countries, which had to go through a 'dual' transition, i.e., had to change simultaneously and fundamentally both political and economic systems, institutions must naturally be at the center of our research interest. The nature of transition consists of very deep and far-reaching changes in all basic institutions. However, because of the very fundamental nature of post-communist transition, institutional changes seem to have taken on, to a certain extent, the character of endogenous rather than exogenous variables. This is that they are an effect of the reforms rather than independent factors determining their course and outcomes.

Consequently, in analyzing the transition process in former communist countries we consider more or less revolutionary changes in the political elite as an exogenous factor determining the initial stage of political and economic reforms in the late 1980s and start of the 1990s (see Balcerowicz, 1994; Mau and Starodubrovskaya, 2001; Aslund, 2002; Dabrowski and Gortat, 2002). In those countries where such elite changes went deeper a larger political window of opportunity for reforming both political and economic institutions was opened.

Changes in economic and political institutions are strongly interrelated. Referring to terminology proposed by Ruis and van de Walle (2003) we are seeking to determine how changes in *high level* rules, i.e. political institutions, influenced the *medium level* set of rules, i.e. economic institutions. However, we also want to look at the opposite relation, i.e. how economic institutions and the economic situation affected the political sphere and changes in political institutions. In the case of Russia it would be particularly interesting to analyze how the imperfect outcomes of the first stage of the economic transition helped so-called 'early winners' to 'capture' key state institutions and their role in subsequently distorting the political system.

The dominant analytical framework for this study is that offered by political economy analyzes. In addition, we have sought to draw from a large body of empirical studies investigating interrelations between political and economic reforms, problems of building and sustaining pro-reform coalitions, the conditions conducive to opening political windows of opportunity for radical reforms, reform cycles and the political costs of reform in relation to both post-communist countries[3] and other developing countries.

The thematic framework of the project directed our research efforts towards identifying the political and institutional factors that have determined the course of economic reforms in Russia and their changing fortunes. To obtain a fuller diagnosis we have adopted an interdisciplinary approach, involving the conceptual frameworks and research instruments proposed by various academic disciplines such as political economy, sociology, political science, political and economic history, institutional economics, macroeconomics, microeconomics and social policy (the latter in relation to part of reform outcomes).

Our case study is mainly of a qualitative and narrative character. To economize research efforts and financial resources we resorted to existing literature and research results on related topics, including our own (CASE and IET) previous analyzes.

However, we have also sought to underpin our qualitative analysis with a more formal, quantitative examination of political trends based mainly on electoral statistics. This analysis,

[13] In the case of post-communist countries see e.g. FH (2001); World Bank (2002); EBRD (2000; 2001; 2002); Aslund (2002); Dabrowski and Gortat (2002). Some active architects of the economic reforms have also delivered personal insights (see Gaidar, 1999; Klaus, 1997).

based on the concept of public demand for reforms and new institutions, proposed by Mau et al. (2001), and based on the theory of public choice and Balcerowicz's (1995) analysis of the political economy of transition. If one assumes political parties in a transitional democracy to be bearers of particular economic, social and political strategies, election results may reflect voter demands for particular institutional packages.

The paper is organized as follows: Chapter 2 contains a short history of the Soviet/Russian political and economic reforms. As well as 1985 and 1991, we have chosen 1994 and 1998 as two other turning points allowing a sub-periodization of our analysis. The first date can be considered the end of the 'revolutionary' period of political and economic reforms. In addition, the first full-scale currency crisis (so-called 'Black Tuesday' of October 11, 1994) finally pushed the political elite to stop its openly pro-inflationary macroeconomic policy. The second date was again marked by the full-scale currency, debt and banking crisis of August 1998 which opened (with a certain time-lag) the path towards a more responsible fiscal policy and more consistent strategy of both structural and institutional reforms.

Chapter 3 is devoted to empirical analysis of electoral behavior and presents two models (international and interregional), which seek to link the effects of economic reforms to the electoral preferences of society and the basic institutions guaranteeing human rights and civic freedoms. Chapter 4 analyzes the role of the international community in leveraging the process of political and economic reform in Russia. Special attention has been put on actions and programs undertaken by G-7 governments, the IMF and World Bank.

In Chapter 5 we present a broad set of economic and social indicators designed to illustrate the effects of the reform process in Russia. This is, however, a very complicated task as economic and social performance may be affected by many factors other than the reforms themselves. The potentially most logical approach – what would have happened if reforms had not been undertaken or other reform strategies/sequencing had been chosen – is not analytically feasible in its pure form. Counterfactuals can be the subject of interesting intellectual speculation but cannot act as a sufficiently precise quantity simulation *ex post*. Thus, comparative cross-country analyzes (particularly comparing Russia to more successful reformers in the CEB region) was the only feasible research technique that might offer at least a partial answer to this question (although, again, leaving a substantial margin for the impact of other factors, such as different starting points and the geopolitical environment). This approach has been largely used here where data availability and comparability have allowed. Chapter 6, the last one, tests the study's central hypotheses. The analysis has a narrative character and refers to findings and conclusions drawn from the preceding chapters.

2. History of the Soviet/Russian political and economic reforms 1985-2002

2.1. The end of the communist 'economic miracle'

The stagnation, crisis and finally collapse of communist regimes did not result just from a fatal coincidence of circumstances or political error. It was also an outcome of their deeply rooted economic inefficiency. One can find detailed arguments to support the unavailability of such an outcome in a number of publications, starting from the very early critics of the socialist/communist economy at the beginning of the 1920s (see Brutskus, 1922; Mises, 1981) and ending with *post factum* analyzes of the economic and political roots of its collapse (see Ofer, 1987; Gaidar, 1997; Gaidar et al., 2003; Aslund, 2002).

Olson (2000, pp. 100, 129) argued that under the Stalinist regime regular and large-scale repression helped subdue special interest groups, thus providing relative transparency and diminishing the losses caused by inefficient bureaucratic control. However, the classical totalitarian model was significantly modified immediately after Stalin's because the Stalinist elite was deeply concerned to protect its personal safety. The price paid for this immunity was the gradual growth of an informal bureaucracy and special interests groups (Olson, 2000, Chapter 8), further depletion of transparency and a deepening of systemic sclerosis.

In fact, very few people noticed the gradual weakening of the communist regime and Soviet state. Domestic public opinion tended to over rather than underestimate the power of the state. The same went for Western scholars and commentators, many of whom were unable to forecast the collapse of the USSR even when it appeared unavoidable (see e.g. Huntington, 1991).

Economic stagnation and gradual loss in geopolitical rivalry with the US and other Western countries were the two main fields where signs of the coming decline first had been noticeable. As result by the early 1980s the USSR had lost any real financial room for maneuver it had had earlier. In order to continue economic expansion within the previous economic model (and avoid any serious reforms) the Soviet economy had increasingly to resort to foreign borrowing. Large-scale use of foreign credits resulted in a continuously growing debt-service burden: USD 5.9 billion in 1984 and USD 15.1 billion in 1986.

When Gorbachev came to power in 1985 the economic situation was only superficially stable (in the sense of Brezhnev-era 'stability'). Maintaining the then level of production and consumption, let alone raising it, depended on uncontrollable external factors: world oil and gas prices, discoveries of new oil and gas fields with low extraction costs and opportunities to issue low-interest debt. However, a dramatic fall in world oil prices (almost twofold in 1985-1986 compared to 1984 and more than threefold in constant prices compared to 1980 – see Table 2.1) and an absolute decline in export earnings (USD 91.4 billion in 1983, and USD 86.7 billion in 1985) signaled a further deterioration in the financial situation. The USSR's failure in the Arms Race was becoming unavoidable and obvious to the new leadership.

Diplomatic concessions granted in 1985-1989 to the US and other Western countries and the 1988-89 political reforms issued a clear signal to society and the intellectual elites that the Communist Party and Soviet government were weakening. The willingness to use power (including physical repression) was perhaps the key factor stabilizing the socialist economic system and the main condition of its efficiency and manageability.

Table 2.1. Spot crude oil prices, 1972-1998, USD/bbl

Year	**1972**	**1973**	**1974**	**1975**	**1976**	**1977**	**1978**	**1979**	**1980**
Dubai*	1.90	2.83	10.41	10.70	11.63	12.38	13.03	29.75	35.69
Brent†	-	-	-	-	12.80	13.92	14.02	31.61	36.83
Year	1981	1982	1983	1984	1985	1986	1987	1988	1989
Dubai*	34.32	31.80	28.78	28.07	27.53	12.95	16.92	13.19	15.68
Brent†	35.93	32.97	29.55	28.66	27.51	14.38	18.42	14.96	18.20
Year	1990	1991	1992	1993	1994	1995	1996	1997	1998
Dubai*	20.50	16.56	17.21	14.90	14.76	16.09	18.56	18.13	12.16
Brent†	23.81	20.05	19.37	17.07	15.98	17.18	20.81	19.30	13.11

Notes: * 1972-1985 Arabian Light, 1986-1998 Dubai; †1976-1984 Forties, 1985-1998 Brent.
Source: BP Amoco Statistical Review of World Energy, June 1999

The protracted fiscal crisis caused primarily (but not exclusively) by the fall in world oil prices and anti-alcohol campaign considerably narrowed political room for maneuver (see Gaidar, 1997, pp. 161-173). Bureaucratic and political conflict between different sectors caused by their divergent interests (typical for a centralized industrial economy) overlapped with the conflict between profitable and loss-making enterprises within sectors. A conflict between strengthened regional elites and the central (Union) elite, as well as differences of interests between individual Union republics and regions, were similarly exacerbated. Increasing splits and tensions within the *nomenklatura* could be interpreted as a reaction to the excessive stability of the 1970s and early 1980s when all personal mobility was effectively frozen. All of this created a potentially ungovernable environment.

2.2. The destabilizing effects of the 'Perestroika' period 1985-1991

In his first attempt to overcome economic stagnation and political and social 'sclerosis' Mikhail Gorbachev resorted to a typical 'mobilization' approach well-known from communist history. The slogan 'acceleration' (*uskorenie*) meant in fact a new industrialization drive, as it was dramatically increasing savings and investment rates (by administrative means) and shifting the bulk of resources towards development of the machine-building complex. At the same time, the new leadership proclaimed the development of a consumer market (at least partially) and its intention to increase living standards. Obviously, the two goals stood in contradictory to one another (see Mau, 1996).

On the social front, two campaigns were initiated – an anti-alcohol drive and the 'fight against non-labor incomes' – which had obvious negative effects for both public finances and the prospects for liberalizing the economic system.

However, the key difference between the new leader and previous newly appointed general secretaries (like Yurii Andropov in 1982) lay not in his rhetoric but in his clearly demonstrated reluctance to use violence (liberation of dissidents, censorship softening). From the very beginning 'openness' (*glasnost*') became the leading, and far from empty, political slogan. The political atmosphere in the previously totalitarian state and society started to change very quickly (see Grachev, 2001).

However, as mentioned in the previous section, actual or threatened coercion had acted to guarantee the stability and manageability of the communist system. But with Gorbachev's reluctance to use repression the mid-level *nomenklatura* (basically, managers of large enterprises) got the signal that Andropov's 1983 nightmare (massive arrests of managers under the slogan of fighting corruption and imposing discipline) had been left in the past.

Furthermore, enterprise directors became the main beneficiary group of the economic reform, which was an important component of the 'reconstruction' (*perestroika*) process. The Law on State Enterprise adopted in 1987 gave state owned-enterprises (SOE) and their managers substantial autonomy without financial responsibility. To some extent the new law followed the experience of 'market socialism' reforms in Yugoslavia, Hungary and Poland, although its conceptual and legal consistency was much lower, the external environment of SOE activity remained mostly non-market (with most prices continuing to be administratively set), macroeconomic policy much looser and enterprise budget constraints much softer, all compared, for example, to Hungary or Yugoslavia.

In 1988 two other key systemic innovations were introduced. The Law on Cooperatives gave more freedom in creating new firms in the legal form of co-operatives, as a 'pure' private ownership had still not been legalized. The Law on Leasing allowed for partial ownership changes in the existing SOE using the form of collective leasing (*arenda*). All three laws opened the process of spontaneous de-etatization of the Soviet economy, mostly through profit and asset stripping from the existing SOEs to new quasi-private entities. Profits were in effect 'privatized' and losses 'socialized,' putting an additional burden on the deteriorating state budget (which already suffered from low oil prices and the negative fiscal consequences of the anti-alcohol campaign).

Overall, these partial and chaotic reforms did not create a coherent and critical mass of changes. They were sufficient to destroy the command system but insufficient to build a new market one and led to a loss both of microeconomic control over the economy (an ownership and institutional vacuum) and the accumulation of huge macroeconomic imbalances (the hidden hyperinflation of 1990-1991).

Because the political reforms of the Gorbachev period (partial political liberalization and democratization) went further than the above described economic changes this discrepancy created fertile soil for various kinds of social and macroeconomic populism. It also sped up the process of disintegration of the Soviet empire, which was probably unavoidable anyway under any political liberalization scenario. However, the process of political emancipation of the national republics in the context of an insufficiently reformed economic system could do nothing but add to the macroeconomic chaos. In 1990-1991 the Soviet authorities' effective control over fiscal and monetary policies was progressively undermined by the republican authorities, with the Russian Federation in the lead (see Dabrowski, 1997).

The last two years of the Soviet Union and Gorbachev's rule brought even more contradictory attempts to resolve the mounting economic and political crisis (see Mau, 1996; Gaidar et al 2003; Gaidar, 1999; Dabrowski et al., 1993). For example, the '500 Days Program' prepared in summer 1990 by a group of young economists at the initiative of the government of the Russian Federation (including the then Deputy Prime Minister Grigorii Yavlinskii) advised far-reaching privatization, de-monopolization and building market structures as the first step, followed by macroeconomic stabilization and price/trade liberalization as the final step (see Yasin, 2003). The plan's authors unrealistically assumed that mass-scale cash privatization alone would allow the budget to be balanced and problems of macroeconomic disequilibrium to be resolved (the fiscal deficit was ex post estimated to reach a level of 31% of GDP in 1991 – see IMF, 1992, p. 13). However, they well understood that gradual reforms would not work given the limited political resources available (window of opportunity)[4].

The '500 Days Program' was formally accepted by President Gorbachev but never implemented by the Soviet government of Prime Minister Nikolai Ryzhkov. When the latter was replaced by the new government of Valentin Pavlov an attempt at a Soviet-conservative 'stabilization' (see Mau, 1996) was undertaken at the beginning of 1991, involving a non-equivalent exchange of old banknotes and administrative price adjustment. Both measures failed to

[4] Ex post, voter support for economic reform weakened significantly after the April 1993 referendum and before the December 1993 Duma elections – almost exactly 500 days after the reforms started in earnest in January 1992.

restore market equilibrium. Finally, the 'hardliners' made the dramatic and unsuccessful attempt to save the totalitarian system and Soviet empire through a coup d'etat in August 1991. Their failure brought an immediate administrative dissolution of the CPSU and opened the way to the final collapse of the Soviet Union at the and of 1991.

2.3. 'Revolutionary' period of reforms, end of 1991-1994

The dramatic events of 1991 – the unsuccessful coup d'etat in August 1991, the political collapse of the USSR and severe macroeconomic crisis – created the foundations for the democratic and market transition in Russia. The first post-communist government in Russia, headed formally by President Boris Yeltsin and with an economic team led by Yegor Gaidar and Anatoliy Chubais, prepared a comprehensive program for market transition, including price liberalization, macroeconomic stabilization and mass voucher-type privatization. Both the economic team itself and the designed program did not differ in terms of their professional quality from those observed in CEB countries. However, political support for market reforms in Russia turned out to be weaker and more fragile than in more successful transition countries.

As result, reformers became politically isolated as early as the first few months of transition. They were forced to accept many compromises[5], to form political alliances not based on program principles and accept second- and third-best choices in order to be able to move forward. This led to a slow pace of reform and inconsequent implementation, with many dramatic turning points, which in turn further undermined political support for reform and the reformers' own political leverage.

The basic factor underlying such difficulties was connected with only partial change of political elite in the course of the 'revolutionary' events of 1991 and resulting problems organizing a stable pro-reform coalition. At the beginning of the transition, the political system remained largely unchanged compared to the late-Soviet period. This played a large part in leading to the dramatic constitutional crisis of 1993.

Only the series of 1993 political events – the April referendum, which confirmed President Yeltsin's mandate to carry out economic and political reforms, the forced dissolution of the anti-reform parliament in September, the unsuccessful coup d'etat attempted by leaders of the dissolved parliament in early October, the referendum and general election in

[5] Such compromises were taken by political opponents as signs of the reformers' weakness and provoked further anti-reform pressure (see Zhavoronkov and Yanovskiy, 2001). Compromise is a tool for coordination of interests in a stable democracy. It is based on the refusal of both sides to use violence against one another. More precisely, compromise is based on a refusal to seek damages clearly disproportionate to the value of a subject to any given dispute. Unfortunately, this kind of 'compromise culture' did not exist in the first stage of transition in Russia.

December – opened the way to the adoption of the new post-communist constitution and far-reaching changes in the political system. The constitution of 1993 was designed to strengthen the prerogatives of executive power (a presidential-parliamentary regime), build in the necessary checks and balances (mostly between legislative and executive branches of government), prevent territorial disintegration of the Russian Federation and guarantee basic civic and economic freedoms.

In spite of its pro-democratic and pro-market character the new constitution failed, however, to increase the political influence of the reform camp because communist and other populist parties dominated the State Duma (lower house of parliament) until 1999. Only the general pro-reform orientation of President Yeltsin, his determination to avoid a communist restoration and his political skills in retaining a hold on political power and rotating reform-minded politicians in subsequent governments[6] kept the limited pro-reform momentum going over the entire decade. On the other hand, Yeltsin's presidency can be characterized by numerous weaknesses, such as the lack of a stable and well organized pro-reform political camp, capricious and unpredictable personal policy, a strong populist bias in many decisions and significant fluctuation in his public activeness, which was additionally complicated by his serious health problems.

The above mentioned unfavorable political conditions did not prevent Gaidar's team from conducting wide-ranging price liberalization on January 1, 1992. This was a critical step in breaking with the command economy and allowed market forces to start working. It also created room for future macroeconomic adjustment and the gradual elimination of market distortions. Firstly, it was necessary to reduce fiscal imbalances, as many prices had been previously heavily subsidized. Without free prices it would have been difficult to introduce VAT. Secondly, price liberalization removed the monetary overhang created by the inflationary policies of previous years. Thirdly, changes in relative prices laid the preconditions for a more efficient distribution and use of scarce resources. Fourthly, free prices pushed enterprises to compete on the market. Finally, the disappearance of product shortages was reflected in household behavior, which sharply reduced speculative demand and eliminated long lines in front of shops and the black market.

Elimination of most foreign exchange restrictions and unifying the ruble exchange rate in summer 1992 led to a reduction in explicit and implicit import subsidies. Opening up the economy was as important as domestic price liberalization as it stimulated, within a short period of time, a substantial inflow of consumer imports and provided a market solution to the problem of chronic product shortages and the poor quality of the consumer market. Elimination of export restrictions took more time (until 1994), creating serious distortions

[13] Each year of the 1990s brought at least one serious reorganization of federal government. Although Viktor Chernomyrdin kept his position of Prime Minister for a relatively long period of time (December 1992 – March 1998) economic portfolios in government were subject of frequent rotation.

and sources of rent extraction. Domestic energy and oil prices were never adjusted to the international level, although they reached their highest level just before the August 1998 crisis. Distortions led to income and wealth inequalities, continuing macroeconomic disequilibrium, various pathologies, etc.

Unfortunately, subsequent attempts at macroeconomic stabilization undertaken in 1992, 1993 and 1994 failed due to the strong resistance of well-organized lobbies of 'red' industrialists, agrarians, heavily subsidized regions and emerging oligarchs – early winners of the incomplete liberalization, the palliative reforms of the Gorbachev period (see above) and macroeconomic disequilibrium. In 1992-1993, anti-stabilization and pro-inflationary forces dominated the Congress of Peoples Deputies (the highest legislative body at the time) and the Supreme Council (the permanent legislative chamber), in turn therefore also controlling the Central Bank of Russia, which was legally and politically dependent on the legislative branch of government. In addition, the ruble zone, with fifteen independent central banks, continued to exist, making monetary control virtually impossible. The process of introducing national currencies in FSU countries was not completed before the second half of 1993 (see Dabrowski, 1997, Odling-Smee and Pastor, 2001).

Mass privatization was the only institutional component of the initial reform package, which was implemented quickly but at the price of many substantial compromises granted to influential lobbying groups. The first of them concerned the dominant method of privatization. What had been the subject of a long intellectual and political debate in other countries (in Poland such discussions lasted at least two years) had to be decided in Russia within just a few months. The choice was made in favor of voucher privatization, which had been started before only in the Czech Republic, the first country trying out this method. In spite of continuous criticism of this privatization approach (Stiglitz, 1999a; 1999b; Ellerman and Stiglitz, 2000), the decision taken at the time seems now to have been the right one. **Firstly**, other methods of privatization would not have brought fast ownership changes in big enterprises for technical reasons. **Secondly**, this was the only politically feasible method at the time. **Thirdly**, it allowed the spontaneous and non-transparent privatization based on the ownership experiments of Gorbachev era (see above)[7] to be halted.

For the same political reasons, which largely inclined towards voucher privatization, the government accepted the compromise, giving a significant stake of shares to insiders (employees and managers). This slowed down the process of enterprise restructuring but made it possible both to get parliamentary approval and to create a strong interest in ownership changes at the enterprise level. The experience of Ukraine a few years later showed that smaller privileges to insiders can lead to lower interest in privatization from this important social constituency and, therefore, to a very slow pace of this process (see Snelbecker, 1995).

[7] This quasi-privatization method has been strongly defended and advocated by Stiglitz and Ellerman [2000]. See also polemics of Dabrowski, Gomulka, and Rostowski [2001].

What was worse, the very strong political position of various branch lobbies and 'red' directors made carrying out mass de-concentration and de-monopolization as the step preceding privatization (as was done, for example in Poland, Hungary and the Baltic countries) impossible. This also complicated the restructuring process, made the domestic market less competitive and contributed to the emergence of powerful industrial-financial groups. Additional distortions came from the unfavorable macroeconomic and microeconomic environments in which privatization had to be conducted: very high inflation, incomplete liberalization and lack of a proper legal and regulatory environment, including law enforcement.

At the beginning of 1994, after most reformers (apart from Deputy Prime Minister in charge of privatization Anatolii Chubais) had left the government following December 1993's parliamentary election, the mass privatization program came under threat. The supply of shares was insufficient to cover all vouchers and the earlier set deadline for the program of June 30, 1994 was moving ever closer. In this context, another controversial decision was taken: to offer a significant portion of shares in two large energy monopolies – RAO EES (United Energy Systems) and Gazprom – in exchange of vouchers. This step saved the voucher program but seriously complicated the further process of restructuring both monopolistic giants.

When mass privatization was wound down and the cash privatization that followed had problems taking off (for political and administrative reasons) a group made up of Russia's largest private banks came up with a 'loans-for-shares' scheme (*zalogovye aukciony*). The government (including its reformer wing) accepted the idea in 1995. The rationale here was predominately political: to enable privatizations blocked by anti-reform groups in the government and parliament and reward the oligarchs who had promised support for President Yeltsin in the 1996 presidential election (see Yanovskiy, 2001).

However, the 'loans-for-shares' scheme increased the non-transparency of the Russian privatization process and brought several negative consequences. **Firstly**, the federal budget lost potential proceeds as the most attractive assets were sold far below their potential market price. **Secondly**, this scheme helped to build strong financial-industrial groups controlling Russia's economic and political life over the next few years. **Thirdly**, the societal legitimization of the privatization process was seriously undermined.

In fact, a very similar political concession had been granted to the emerging oligarchs two years earlier, before the December 1993 elections. At that time, President Yeltsin issued a decree demanded by the Association of Russian Banks and supported by all reformers in the government, which seriously restricted the entry of foreign banks into Russia. This heralded the beginning of unfavorable developments in the Russian banking sector, lacking in proper competition, and eventually contributed to the 1998 banking crisis.

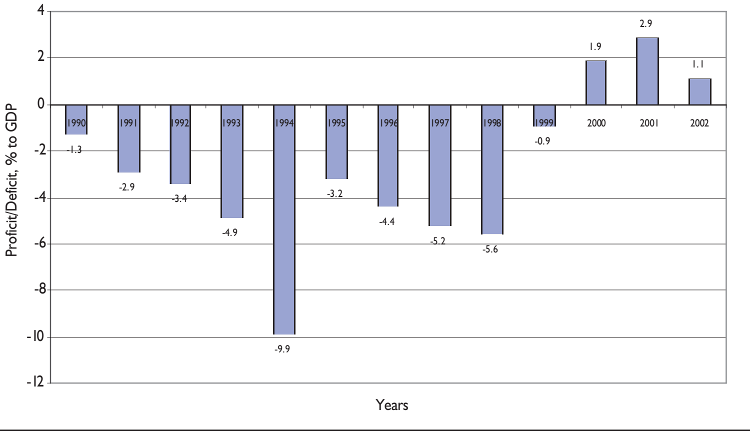
Reformers had to pay a very high political price for some of the above-described compromises. **Firstly**, they were blamed for building a crony capitalism that, at least partly, had stemmed from the above-mentioned compromises. In the popular view, the free market (which had never really existed in Russia) became associated with oligarchic fortunes and numerous economic and social pathologies. **Secondly**, the reform camp's political room for maneuver became increasingly limited because it had to fight not only with the supporters of the old economic regime but also with omnipotent oligarchs who dominated Russian politics (capturing all branches of government, particularly the executive) in the second half of the 1990s.

The slow pace and inconsistency of the Russian economic transition prolonged the period of deep output decline and dramatically increased income and wealth differentiation (see Chapter 5). Politically, it resulted in increasing support for populist forces, reflected in the relative success of the communists and their allies in the December 1995 elections to the State Duma.

2.4. The fragile and illusory stabilization of 1995-1998

The macroeconomic and political shock caused by the fully-fledged currency crisis (so-called 'Black Tuesday' of October 11, 1994)[8] forced the authorities to seek ways of restoring macroeconomic stabilization in 1995. This resulted in gradually decreasing inflation to a low two-digit level. However, this stabilization ultimately proved fragile and illusory because of consistent and serious flaws in the fiscal and structural spheres: the weakness of the basic state institutions, insufficient structural reforms, unreformed social policy, agriculture and energy sectors, paternalism and soft budget constraints in relation to larger enterprises reflected in an explosion of non-payments, arrears and barter transactions.

Figure 2.1. General Government Budget Balance



Sources: RF Central Bank www.cbr.ru: 'Russian Statistical Yearbook 2002', State Statistics Committee, Moscow, 2002: 'Russia in Figures 2003', State Statistics Committee, Moscow, 2003.

[8] In fact, the ruble depreciated substantially earlier – in September 1992 and September 1993 – but this did not lead to an immediate correction in macroeconomic policy.

After some fiscal tightening at the end of 1994 and 1995 the general government deficit started to grow again in 1996-1998 (see Figure 2.1), as a consequence of the presidential election campaign in 1996, the post-election political instability connected with President Yeltsin's poor health and frequent changes in government, the deep-seated political conflict between the mainly market-oriented government and communist-dominated Duma, serious flaws in Russian federalism and the increasing influence of the oligarchs. The lack of a pro-reform majority in the Duma and increasing political strength of the oligarchs may be considered the most important factors hampering necessary fiscal, structural and institutional reforms.

The history of the two pre-crisis governments in particular is very telling. In the face of a rapidly increasing fiscal deficit, public debt and slow pace of structural reforms, President Yeltsin decided in February 1997 to reorganize the government of Prime Minister Victor Chernomyrdin by nominating three new Deputy Prime Ministers, Anatolii Chubais, Boris Nemtsov and Oleg Sysuev and other reform minded ministers (known as the government of 'young reformers'). The new cabinet's program included, among other things, a balanced budget based on realistic macroeconomic assumptions, fundamental reform of social assistance, targeting it towards the most vulnerable groups in society, a set of anti-corruption measures, including transparent public procurement procedures, an obligatory declaration of personal income and property by civil servants, moving budget accounts from private banks to the Treasury, the elimination of barter transactions, netting-out operations and money surrogates, the development of local self-government, open and transparent privatization tenders, regulating natural monopolies and improving tax enforcement in relation to larger taxpayers (see Zhavoronkov, 2001, Chubais, 1997)

However, this program was immediately met by the fierce resistance of the oligarchs. The first relatively transparent privatization tender, of Svyazinvest in June 1997, provoked a so-called 'war of the oligarchs' war, with a massive attack on the 'young reformers'. As a result, the first government with a comprehensive program of structural and institutional reform failed completely to carry them out.

By the time the first signs of financial crisis appeared in November 1997 the government of the 'young reformers' had already lost its political momentum. The same happened with the next reform-minded cabinet, of Sergei Kiriyenko, which was appointed in April 1998. As a result, reformers were unable to convince the Duma of the need to carry out any of the fundamental reforms needed to improve the fiscal situation and avoid financial crisis and had to concentrate, in fact, on managing the crisis and calling for international assistance (Gaidar et al., 2003; Zhavoronkov, 2001). Finally, they also had to take all the blame for the August crisis and lost any opportunity to influence economic policy for at least a year.

The main macroeconomic differences compared to the 1992-1994 period were: much tighter monetary policy and financing most of the fiscal deficit through Treasury bills and bonds. However, this was not enough to guarantee macroeconomic stability in the longer term. When the external environment deteriorated as a consequence of the Asian crisis, i.e. international oil prices decreased and financial investors started to be less enthusiastic about investing in emerging markets, Russian resistance to speculative pressure against its currency and Treasury securities crumbled. These unfavorable developments led to a large-scale financial crisis, whose first symptoms were observed in the fall of 1997 but which fully erupted in August 1998.

2.5. Post-crisis period (1999-2003)

The August 1998 crisis was a dramatic turning point in the history of the Russian economic transition (see Antczak, 2003). The more than three-fold devaluation of the ruble brought a new round of inflation and depreciated, in real terms, wages, salaries, pensions and other sources of income. The collapse of many 'oligarch' banks undermined the credibility of the financial system and provoked a new wave of dollarization. However, the immediate consequence of ruble devaluation and decreasing real wages was to help many domestic producers (particularly in the import-competing sector) to take off[9].

Default on government securities closed the Russian government's access to international financial markets, enforcing fiscal adjustment and hardening financial discipline, which had earlier been politically impossible[10]. Paradoxically, this adjustment was conducted by the left-wing government of Prime Minister Evgenii Primakov backed by the communists and their allies in the Duma despite its temptation to experiment with various populist and anti-market ideas[11].

The December 1999 elections to the Duma and March 2000 Presidential elections reconstructed Russia's political landscape. For the first time parliament was supportive of the market-oriented policies of President Vladimir Putin and Prime Minister Mikhail Kasyanov and their legislation initiatives. This significantly helped speed up the pace of economic and institutional reform and made it possible for Russia not to lose out on any external windfall gains (in the form of high oil prices). Russia has enjoyed a fiscal surplus for the entire period under consideration and the Russian economy has started to grow at quite an impressive rate.

A number of important reforms have also been undertaken, including the consolidation of state institutions, improving the structure of Russian federalism (including in the fiscal

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[9] A more detailed analysis of the sources of economic growth in 1999-2002 can be found, inter alia, in IET (2003) and Dabrowski (2003).

[10] Fiscal adjustment was partly possible due to the halting of public debt servicing after August 17, 1998.

[11] Several such ideas were elaborated at the end of 1998 by the group of distinguish Soviet-era academics and 'reformers' (Leonid Abalkin, Dmitriy L'vov, Nikolai Petrakov, Stepan Sitaryan and others). They advised, for example, 'pumping' the money supply to reach a monetization level (M2/GDP) equal to Western European or at least Central European countries. They were also in favor of 'selective' government investment programs in industry. See Zhavoronkov (2001) for analysis of the economic policy dilemmas of Primakov's government.

sphere), the reconstruction of the legal system and judicial branch of government, simplifying the tax system, changing the pension and health systems, adjusting housing and municipal services to the market environment and realities, restructuring and regulation of natural monopolies (electricity generation, transportation and supply, railway transportation), making land resources (including agriculture land) tradable, deregulation of business activity and advancing Russia's accession to the WTO. However, one must remember that the conceptual basis for many of these reforms had been worked out earlier, sometimes much earlier (for example, in the early 1990s) and it was only a matter when the political window of opportunity would open for them to start in the recent period. In addition, most of these reforms are still only at the conceptual and legislative stages or their implementation was started not long ago.

2.6. The overall record and list of unresolved problems

The results of the Russian economic transition raise many controversies, sometimes of a clearly emotional character. In attempting to define the overall progress made in building a market economy in Russia one might choose the term 'moderate', that is compared to other transition countries: the 'fast' reformers of the CEB region, on the one hand, and the 'slow' reformers, such as Ukraine, and the 'non-' reformers, such as Belarus, Uzbekistan and Turkmenistan, on the other.

Without any doubts, the Russian economy can today be considered predominantly market-based, something that seemed an unrealistic dream until the end of the 1980s. The temptation to return to a command economy, which has been experimented to some extent in neighboring Belarus and which seemed to be a real danger in Russia at least until the 1996 presidential elections, no longer appears to be a real danger. Institutional and ownership changes have gone too far to be easily reversed and the main political forces (including the Communist Party of the Russian Federation) are apparently not interested in such an approach.

The international perception of Russia's economic transition has changed dramatically in the course of the last few years: from deep criticism and extreme pessimism in the aftermath of the 1998 financial crisis to acknowledgment of the reforms that have been conducted and the prevailing view in many parts that Russia is a promising reformer.

However, some important enclaves of the old economic system (only slightly modified) have yet to disappear. In first instance this relates to agriculture, communal housing services, a significant chunk of the energy sector, most of the country's social services and its social safety net, including the pension system. Other sectors, mainly the natural monopolies, suffer from huge distortions due to the lack of transparent regulation, excessive politicization, incomplete and non-transparent privatization, administratively imposed low user tariffs, etc.

These sectors remain the objects of intensive rent seeking by competing groups of oligarchs.

The list of unresolved problems contains also several other items such as:

- Poor investment climate caused by lack of effective protection of property rights and personal immunity, weak contract and law enforcement and a poorly working justice system. This has damaged first and foremost SME (see Mau and Yanovskiy, 2002 for detailed analysis) but also FDI.
- Chronically underinvested infrastructure, with growing economic and technical risks.
- Ineffective, unreformed and costly army, police (*militia*) and security (Federal Security Service – Russian acronym FSB) forces and excessive militarization of the Russian state and economy as legacies of the totalitarian system (see Yasin, 2002). The *militia* and FSB cannot provide elementary security to citizens and business, being instead a frequent source of business harassment, violation of civil rights and corruption.

Appendix 2.1: The Main Reform Events and Players, 1990-2003

Year / stage/ program	'Red' directors lobby	Regional elite	Advocates of communist 'restoration'	Military, police and state security elite	'Oligarchs'	Pro-reformist coalition (intellectuals, small, medium and, partly, big business, etc)
1990/ late 'Perestroika'/ Ryzhkov-Abalkin program; 500 Days program		First opportunities of strengthening their autonomy	-	-	Not existed	Appearance and de-facto legitimization of anti-communist opposition, removal of Article 6 -of the Constitution of USSR, which gave CPSU the 'ruling role'
1991/ late 'Perestroika'/ Pavlov's program	Tax privileges, concessions in the privatization legislation	Regions' 'sovereignty' (by-product of Yeltsin-Gorbachev rivalry	-	-	Not existed	Laws on the property, business activity, competition, privatization; defeat of coup d'etat in August 1991
1991 – start of 'revolutionary' reforms / Gaidar's program	-	-	-	Status-quo preservation	Not existed	Collapse of USSR; Pro-reform choice of the President and Congress of Peoples Deputies (CPD); Formation of reform government; preparing basic reform steps
1992 – start of 'revolutionary' reform / program of Yeltsin - Gaidar government	Price and trade liberalization, subsidized credit lines from summer 1992, acceptance of state holdings, insiders' privileges in voucher privatization, soft budget constraints	-	President's compromise with CPD in December 1992: Gaidar's resignation, calling off referendum on land privatization	Status-quo preservation; autonomy in budget management	Origins: high inflation and keeping budgetary accounts in "friendly" banks	Price and trade liberalization Start of large-scale privatization
1993/ reform slowing down/ -	As above	Concessions in privatization; opportunities to get benefits from the conflict between legislative and executive branches	Unsuccessful attempt to restore price control, compromises with sectoral and territorial lobbies	As above	High inflation and budgetary accounts in "friendly" banks, import and export control, low costs of obtaining privatized assets	Boris Fedorov becomes the Minister of Finance, dissolution of CPD, adoption of the new Constitution, the first free parliamentary elections, small and voucher privatization takes off

Year / stage/ program	**'Red' directors lobby**	**Regional elite**	**Advocates of communist 'restoration'**	**Military, police and state security elite**	**'Oligarchs'**	**Pro-reformist coalition (intellectuals, small, medium and, partly, big business, etc)**
1994/ end of 'revolution' period/ -	Soft budget constraints	-	Budget concessions, government nominations (e.g., Ministry of Justice, Ministry of Agriculture)	Status-quo preservation, forgiveness for passive behavior during October 1993 rebel, Chechen War -I	Soft budget constraints, beginning of issue of Treasury bills (GKO)	Surviving of pro-reform wing in government, adoption of the Civil Code (Part One)
1995/ beginning of 'post-revolution' stabilization/ -	Government non-intervention against managers' abuses of property rights	Active 'participation' in the privatization process	As above	Stopping reform of army and police, Continuation of the Chechen War -I	Disinflation, massive issue of GKO, 'loans-for-shares tenders and other 'addressed' privatization deals	Disinflation, adoption of the Civil Code (Part Two)
1996/ presidential election - stabilization interrupted (December 1995 July 1996) / -	As above plus subsidized credits and tax forgiveness	As above plus automatic membership in the Federation Council (upper Chamber of Parliament)	As above plus resignation of Chubais, control over General Prosecutor's office	As above	Continuation of privatization abuses, partial privatization of the 1-th and 4-th TV channels (to Boris Berezovskiy and Vladimir Gusinskiy	Adoption of Penal Code, anti-communist rhetoric of President Yeltsin, vetoing laws adopted by pro-communist majority in the Duma, end of the Chechen War -I
1997/ illusory stabilization / -.	Gradual decomposition – end of autonomous role	The same plus regional elections	-	Military reform compromised (elimination of conscription delayed indefinitely)	Weakening Chubais and Nemtsov positions, Kokh and Boiko resignations after the 'book' scandal	'Young reformers' (Nemtsov – Chubais) cabinet, first cases of competitive privatization (*Svyaz'invest*); fighting large tax avoiders, first attempt of military reform (army downsizing), blocking left-winger parliament initiatives, decree on public procurement

Year / stage/ program	'Red' directors lobby	Regional elite	Advocates of communist 'restoration'	Military, police and state security elite	'Oligarchs'	Pro-reformist coalition (intellectuals, small, medium and, partly, big business, etc)
1998/ financial crisis/ 'academics' program, alternative approach by IET	-	Regional price control and trade barriers after August financial crisis	Resignation of Kiriyenko cabinet, Primakov -Maslukov left-wing government Viktor Gerashenko replaces Sergei Dubinin as CBR Governor	As above	Resignation of Kiriyenko government	Appointment of Kiriyenko Government
1999/ post-crisis period /-	-	Active participation of regional leaders in parliamentary election: success of recipient regions	-	Chechen War –II, weakening of political control	Active influence on formation of Stepashin government	-
2000/ post-crisis period / Greff program	-	Regional governors lost seats in the Federation Council but got possibility of a third term, removal of some governors in an election process, limited unification of regional laws	Getting position of Speaker and number of committees in the Duma; partial restoration of Soviet state symbols	As above, first 'spy' trials, taking new business under control	Gradual ousting of non-loyal oligarchs (Berezovskiy, Gusinskiy) while loyalists survived	PIT flat rate
2001 / post-crisis period / Greff program	-	-	-	As above	Non-loyal oligarchs in exile	Deregulation and partial reduction of regional administrative barriers
2002 / post-crisis period / Greff program	-	-	Loss of key positions in Duma;	As above	-	Beginning of railroad and RAO UES reform; adoption of law on technical regulation
2003/ post-crisis period / Greff program	-	Regional and 'oligarchic' elites overflowed United Russia election list	-	As above plus attack against YUKOS	Attack against YUKOS, regional and 'oligarchic' elites overflowed United Russia election list	-

Appendix 2.2. Main institutional changes in Russia, 1985-2003

This appendix contains a list of the main institutional reforms undertaken in the analyzed time period, 1985-2003:

The Gorbachev period, 1985-1991

- Law on State Enterprise, 1997
- Law on Cooperatives, 1998
- Law on Collective Leasing (arenda), 1998
- Political reform since 1988

Period of 'revolutionary' reforms, 1991-1994

- Law on Competition, 1991
- Law on Privatization, 1991
- Law on Militia, 1991
- A new structure of the government of the Russian Federation: elimination of most of the sectoral ministries (Presidential Decree No 172 of 6 November 1991)
- Price and trade liberalization, 1992
- Law on Consumer Rights (1992)
- Privatization decrees (particularly, No. 66 and 721 of 1992)
- Privatization Law 1992 version
- Decree 1400 of 21 September 1993 dissolving the Congress of Peoples Deputies and Supreme Council

The Constitution of 12 December 1993

The period of fragile and illusory stabilization, 1994 -1998

- Civil Code, Parts One and Two;
- Criminal Code;
- Arbitration Procedure Code,
- Federal constitutional laws on the judiciary system and the Constitutional Court
- Law on the Fundamentals of Civil Service
- Law on budgetary classification
- The onset of reform in the housing and communal utilities sector
- Partial reform of military forces
- Partial tax reform: approval of Part One of the Tax Code
- Budgetary Code
- Law on Judiciary Department of the Supreme Court

- Draft law "On the licensing of certain activities", September 1998)
- Federal Constitutional Law "On Government"

The post-crisis period, 1999-2003

- Law "On quality and safety of food products" and relevant regulations, January 2000
- Tax reform: Part Two of the Tax Code
- Land Code and Land Turnover Law
- Onset of the judiciary reform
- Law on Status of Judges (significant simplification of dismissal procedure of judges)
- Criminal Procedural Code (with some new weak guaranties of personal immunity)
- Arbitrage Code, 2002
- The first package of laws on deregulation of the economy, August 2001
- Law on Technical Regulation, December 2002 (liberalization of technical regulations and state standardization)
- Railroad reform bills, January 2003
- Debate on reform of the electricity sector and gas industry, beginning of restructuring of the electricity sector

Appendix 2.3: Professional and political debate on economic problems and economic reforms. Major government economic policy and economic reform programs

This appendix presents a simple overview of the major approaches to economic reform presented in the analyzed period. We have classified them using two groups of criteria: (1) market/non-market orientation, and (2) implementation realism and macroeconomic responsibility:

• **Realism/ Market approach**	• **Etatist/ interventionist**	• **'Free market'**
• 'Realist', i.e. supplied with legislative 'technology for implementation' and taking into consideration (at least partly) macroeconomic constraints	• Ryzhkov/ Abalkin government program of 1990 • Pavlov government program of 'administrative stabilization' of 1991	• Economic Policy Institute (Gaidar) program of 1991 • Government (Gaidar) program of 1992; • Greff program and its 'clones' based on proposals of pro -reform think-tanks (2000 -2003)
• 'Unrealistic' (in the sense of its implementation) and macroeconomically irresponsible (populist)	• 'Academics' program of 1998	• '500 days' Program of 1990

3. Political economy of reform – an attempt at a quantitative analysis

3.1. The importance of election statistics

The main objective of this chapter is to develop a quantitative technique for assessing **public demand for reforms and new institutions**, a concept elaborated by Mau et al. (2001) and based public choice theory and Balcerowicz's (1995) analysis of the political economy of transition.

Our basic assumption is that voter preferences significantly influence the type and particular features of the institutions being formed and, through them, the dynamics of macroeconomic parameters.

If one considers political parties in a transitional democracy to be bearers of particular economic, social and political strategies, election results can reflect voter demands for particular institutional packages. Such an approach needs, of course, to identify the economic and political doctrines offered by political parties and leading politicians and an adequate translation of them into exogenous variables that can be tested using a formalized model (see Mau et al., 2001 for a detail methodology).

Although we are fully aware of the methodological risk connected with quantifying qualitative parameters[12], we have sought to work on the experience already accumulated in previous IET research in this field. We have in mind formalized models explaining growth performance (Mau and Yanovskiy, 2002) and investment risk in regions of the Russian Federation (Mau et al., 2002 b; Yanovskiy et al., 2001) using a set of quantified political/ historical/ cultural variables related to electoral preferences, political programs, ability to build pro-reform coalitions, their sustainability, the historical traditions of democratic movements, the consolidation or fragmentation of political elites, access to free media, etc.

[12] Which has been demonstrated, among other things, by the numerous shortcoming of such respectable international ratings as those proposed by the EBRD (index of institutional reforms), Transparency International (corruption index) and the Heritage Foundation (Index of Economic Freedom). In spite of their weaknesses we use the results of these ratings in Chapter 5.

Election results may be also interpreted (with the help of existing sociological research) for an assessment of certain components of human capital (the ability to adapt, 'social optimism'[13], the attitude to civil self-organizations and cooperation, tolerance levels, etc.).

Several hypotheses were tested using two comparative statistical models (international and interregional), which are elaborated below. Both were based on a common approach and ideas but differed somewhat in terms of the sets of variables they used. The federal election data was used for the interregional test and national election outcomes for the international test.

3.2. The basic model

The significance of political and the associated institutional factors is illustrated using a modified Solow (1956) model. Let us assume that the rate of savings is not exogenously determined but depends on investors' estimates of political and legal risks:

$$s = s(\underset{-}{R_{political}}, \underset{-}{R_{legal}}, \ldots);\ y = y(\underset{+}{s}, \ldots) \qquad (3.1)$$

where s – saving rate; R – investors' risk estimation; y – GDP per capita.

We assume that estimation of investors' political risk decreases with an increase in electoral support for the reformist coalition. The GDP record of transitional post-communist democracies in 2000 relative to 1989 can be explained with $R^2 = 0.34$ and T-statistics=3.127 by voting for reformist parties. Taking in consideration other forms of reformist (counter-reformist) support, a reformist government and reformist majority in parliament during the first years of transition we arrive at $R^2=0.548$ (see Mau et al., 2001 for details). Both factors – a reformist government supported by a reformist majority in parliament – are interpreted by us as the actual window of opportunity for pro-market reforms.

The Russian regional test shows a strong dependence of electoral behavior on the results of the first free elections. Duma election voting for the reformist block 'Vybor Rossii' ('Choice of Russia') in December 1993 can be explained with $R^2 = 0.677$ by voting for Boris Yeltsin on June 12, 1991 (the first free presidential election) and "Yes" to the economic reform policy at the April 1993 referendum. Even the 1999 Duma election shows a statistically significant dependence between support for the SPS (Right-Forces Union) and support for Yeltsin in 1991 with $R^2 = 0.227$ (see Mau et al., 2001 for details).

[13] See, in particular, a survey by the 'Obshestvennoe mnene (Public Opinion)' Foundation on the results of the 1999 election, which is posted on the website www.fom.ru, according to which, of Russia's citizens most able to adapt, 17% voted for the pro-reform SPS (with a national average of 8.5%); while 32% of voters least able to adapt were among supporters of the Communist Party (25%).

3.3. The International Analysis

Our international model covers CEE countries for the period 1989-1999 (apart from Albania, Transcaucasus and Belarus), post-war Germany (1947-1957), Italy (1946-1956) and Japan (1946-1956).

We try to explain GDP dynamics using a set of political and institutional variables. Among the political ones the most important turned out to be:

- Electoral support for anti-reform lists – total votes for the radical left and nationalist blocs (on average for all parliamentary elections)[14]
- Electoral support for social-democratic and conformist lists – total votes for the left and socialist parties that do not fall under the definition of 'radical'
- Electoral support for conservative-liberal (pro-reform) parties
- The rule of a pro-reform cabinet in the first two years after fall of a totalitarian regime
- A pro-reform majority in parliament in the first two years after the fall of a totalitarian regime
- The number of years in office of pro-reform cabinets (in the first decade of reforms);
- The number of years of a pro-reform majority in parliament (out of the first decade of reforms);
- 'Revolutionary' demand for new institutions measured by number of participants in mass actions per 1,000 of the population.

Table 3.1. International model: results of a simple regression analysis

No.	Independent variable (dependent – GDP dynamics)	Coefficient value	T-statistics
1.	Voting for pro -reform parties	0.616	3.127
2.	Participation in mass actions of the revolutionary period	0.515	2.402
3.	The number of years in office of pro -reform cabin ets (out of the first decade of reforms)	0.609	3.069
4.	The rule of pro -reform cabinet in the first decade after fall a of totalitarian regime	0.448	2.004
5.	The pro-reform majority in parliament in the first two years after fall of a totalitarian regi me	0.662	3.538
6.	Court prosecution of the functionaries of totalitarian regime	0,357	2,535

Source: Mau et al. (2001), Mau et. al (2003).

All the explanatory variables are obviously interdependent. For example, the average level of support for the pro-reform parties influences the number of years in office of pro-reform cabinets; a special but very important, and therefore highlighted, case is rule by a one-party pro-reform cabinet in the first two years. Also, the number of years of a pro-reform majority in parliament and the existence of such a majority at the start of reforms are determined by the average level of support and are interconnected.

[14] See Mau et al. (2001, Appendix) on the criteria for classification of the political parties used in this analysis

Table 3.2. Summary Data on Regressions from the Principal Components

Dependent variable	Groups of independent variables	T- statistics	Adjusted R Square	Significance
GDP_{10} / GDP_1 (for transition countries – GDP_{2000}/GDP_{1989})	Election support for reformers	3.190	0.548	0,007
	Mass actions against totalitarian regime	2.787		0,015
	Lack of support for anti -reformers	2.375		0.032

Source: Mau et al. (2001).

That is, the factors cited are linked in a 'chain-like manner', but still supplement each other, enhancing the explanatory power of the model. Such a situation makes it justified and necessary to use the factor analysis method in the international model. As distinct from simple regressions, whose explanatory power does not exceed 0.3-0.35, the model as a whole gives an explanation of more than 0.5 (see Table 3.2).

Restrictions on the electoral rights of key functionaries from the totalitarian regime also positively influenced the model's results (see Regression 6 in Table 3.1).

In addition, we executed a number of statistical tests for various institutions. Taxation, banks and insolvency legislation, business registration and licensing and the number of other institutions appears to be statistically insignificant or less significant than the basic institutional guarantees of human rights and civil liberties illustrated by such variables as number of appeals to international courts, free activity of opposition media, etc. (see Mau et al., 2003a; b, for details).

3.4. The Interregional Analysis

The interregional model based on economic and electoral statistics of 78 Russian regions. Electoral statistics covered three elections to the State Duma: 1993, 1995 and 1999.

3.4.1. The significance of the pro-reform coalition

In the interregional model we tested two dependencies. The first one concentrated on election preferences and was similar to that described in equation 3.1. However, in the absence of good quality and really comparable data on Gross Regional Product dynamics we used other indicators such as rate of growth in number of cars per 1000 residents, personal income tax (PIT) revenue, foreign investment stock in the region and employment in the small business sector.

Table 3.3. Interregional model: Summary Data on Simple Linear Regressions

No.	Dependent variable	Independent variables	T-statistics	Adjusted R Square	Significance
1.	Relative increase in the number of cars per 1000 residents	Dummy on the Regions with common border with Belarus. Poland and Japan	4.454	0.316	0.000
		Voting for pro -reform parties	4.104		0.000
2.	same	Votes cast for anti - reform parties	-2.956	0.248	0.004
3.	Foreign investments, 1998.	Voting for pro -reform parties	4.260	0.186	0.000
4.	Personal income tax revenue increase coefficient (PIT_{1999}/PIT_{1994})	Voting for pro-reform parties	3.523	0.132	0.001

Source: Mau et al. (2001).

The independent variables also needed modification. While the first three political variables were similar to the variables in the international model it was not possible to collect regional data on variables other than just election results. Thus, the explanatory power of the model became weakly comparable with the international one.

Hence, in order to increase the explanatory power of the interregional model, three variables were added, reflecting the peculiarities of Russian political history in the transition period. These were: voting for Yeltsin in the June 1991 presidential election, voting in support of economic reforms at the April 1993 referendum (answer "Yes" to the second referendum question) and voting for Yeltsin in the second round of the presidential elections of July 3, 1996. The latter vote was a pure choice for or against the communist 'restoration' (symbolized by Communist candidate Gennadiy Zyuganov), while the former was for or against the start of radical political and economic reforms[15].

Table 3.3 presents a summary of the most important regressions obtained from testing political variables. All the tested dependent variables (illustrating progress in economic development) were positively correlated with electoral support for the pro-reform parties and negatively with support for anti-reform parties.

[15] Other candidates in June 1991 presidential elections included: former Soviet Prime Minister Nikolai Ryzhkov, opposing market reforms, former Soviet Minister of Interior Vadim Bakatin, a symbol of gradual reforms, and Albert Makashov, a symbol of hardline communism and nationalist xenophobia.

3.4.2. The significance of basic institutions and the pro-reform coalition for the investment climate

The second relation tested can be presented as: $E^{sm\_business} = E(\underset{-}{R^{f\_pol}}; \underset{-}{R^{f\_leg}}, \underset{-}{R^{f\_enf}}, \dots)$

where $E^{sm\_business}$ is small business employment as an indicator of the investment climate, R^{f_pol} is political risks factors; R^{f_leg} is legal risks factors; R^{f_enf} is contract enforcement risk factors. A description of the variables is presented in Tables 3.4

Table 3.4. Interregional model: Description of variables

No.	Variable	Description
		Dependent variables
1.	SMBEMPL01	Average number of employment in small business in 2001
2.	SmBempl_Dyn01	Dynamics of employment in small business, 1995 -2001, in %
3.	FOR_DIRINV	Foreign Direct Investments 1996 -1999
		Independent variables
1.	COURTDEFDM2	At least one law court sentence in the case of offence against personal immunity and the right of judicial defense
2.	SMIRAT99	Freedom of speech ranking for 1999
3.	SMIRAT00	Freedom of speech ranking for 2000
4.	opp_smi_loc	Mass media (published or broadcasted in the region territory)
5.	For_retrans	Local mass media regularly re -broadcasting programs of foreign mass media
6.	Cap_net&forco	Subsidiaries or correspondent networks of Moscow -based mass media
7.	HROactCourt	At least one case won in court by human rights organizations or with their support, 2000
8.	BARR99	Barriers to the movement of goods and services across Russia's regions in 1999
9.	BARR01	Barriers to the movement of goods and services across Russia's regions in 2001
10.	BANKR_EC	The number of pending bankruptcy cases where external management was introduced, 2000
11.	El99right	Electoral support for pro -reform parties, 1999
12.	El99extrem	Electoral support anti -reform parties, 1999
13.	El99confrm	Electoral support for non -communist conformists lists, 1999
14.	Confl01	Conflict between executive and legislative branches of government in region, and between region and municipalities
15.	FIXPRICE	Price control by regional normative act
16.	SOGLPRIC	Informal price control
17.	RESTPRICE	Regulation of trade margins, profit margins, etc.

Source: Mau et al. (2003a)

The regressions with statistically significant outcomes are presented in Table 3.5. The number of pending bankruptcy cases where external management was introduced and regional political conflicts proved non-significant. Barriers to the movement of goods and services across Russia's regions was significant in 1999 but became insignificant in 2001. Price regulation became less significant because of gradual progress in adjusting regional legislation to federal regulations after 2000.

Table 3.5. Investment climate determinants: results of regression analysis

No.	Dependent variables	Independent variables	R^2 (adjusted R-square)	t-statistics
1.	**SmBempl_Dyn**	2.017+ 1.410.5*EL99RIGHT+ 2.053.0*COURTDEFDM2+ 5.9*SMIRAT00	0.289	 3.513 1.531 * 2.076
2.	**SmBempl_Dyn**	6020+ 1965* COURTDEFDM2+ 1211* HROactCourt	0.156	 2.009 3.137
3.	**SMBEMPL01**	-11.349+ 2.049*EL99RIGHT+ 86.7* SMIRAT00+ 22.019* COURTDEFDM2	0.383	 3.158 3.239 2.542
4.	**SmBempl_Dyn**	3750+ 170.3*EL99RIGHT 1322.2* OPPSMI + 1977.6* CapNet&For	0.435	 2.731 3.243 4.498
5.	**SmBempl_Dyn**	5441+ 1.158.5*OPPSMI+ 1.414.8*Cap Net&For+ 1.957.2*For_Retran	0.464	 2.861 3.432 4.669
6.	**SMBEMPL01**	-7148+ 22587*COURTDEFDM2+ 119.6*SMIRAT00	0.308	 2.461 4.578
7.	**FOR_DIRINV**	155+ 307.4*Dumm_Rent - 148.9*RestPrice	0.172	 3.557 -2.384

Source: Mau et al. (2003a).

The obtained results show the importance of both human rights and civic freedoms (regressions 2, 5 and 6 in Table 3.5) and the pro-reformist coalition (regressions 3 and 4) for the investment climate.

3.5. Buying votes and pro-reform coalitions

The authors of the very first IET research on electoral behavior (Gambaryan and Mau, 1997) pointed out the counter-productive (from the point of view of a pro-reform government) practice of subsidizing southern pro-communist regions (the so-called 'Red Belt') out of the federal budget. In fact, pro-reformist regions were punished for loyalty and anti-reform regions enjoyed financial support. Federal transfers gave some additional tiny electoral support in national republics. However, the ethnically Russian populated regions demonstrated a negative correlation between net federal transfers and electoral support for Boris Yeltsin (see Table 3.6).

The conclusion we can be drawn from Table 3.6 is quite clear: a better economic performance of the region is reflected in higher tax revenues per capita collection by the federal budget and higher pro-government electoral support. This phenomenon reflects the rationality of the Russian electorate. However, funding disloyal voters was a clear mistake of the pro-reform camp: a rational leader oriented toward re-election should support loyal and marginal regions. In terms of social groups, the leaders of a pro-reform camp should try to redistribute budget transfers from agriculture to coal mine reconstruction or closure, from Soviet-type farm employees and managers to large city teachers, doctors, etc. In contrast, anti-reform coalition leaders demonstrated high efficiency in using public money to consolidate their electorate[16].

Table 3.6. Federal transfers and support for Yeltsin in the 1996 elections

Budget item	Correlation for all regions but national republics	
	First round	Second round
All direct federal expenditures in the regions per capita, 1995	- 0.077	0.074
Net federal transfers, 1995	-0.626	- 0.487
Federal budget tax revenues per capita, 1 995	0.687	0.603

Source: Gambaryan and Mau (1997).

Table 3.7: Federal transfers and support for the government, 1999 compared to 1995

No.	Dependent variable & coefficients	Independent variables	T-statistics	R^2 adjusted
1.	'Unity' 1999 compared with "Our Home Russia" 1995 %; (Delta_Yed_ndr)	0,276 * (1999 November & December transfers sum) -0,410 * (North Caucasian regions Dummy)	2.415 -3.591	0.139
2.	Delta_Yed_ndr	0,322 * (1999 November & December and 1 -st quart. 2000 transfers sum); (vvp99_2_00sum) -0,413* (North Caucasian regions Dummy)	2.91 -3.735	0.167
3.	Unity 1999, %	0,246* vvp99_2_00sum -0,309* (North Caucasian regions Dummy)	2.118 -2.669	0.083

Source: Mau et al. (2003b)

The above described practice of supporting hostile voters changed only at the end of 1999. In contrast to the years 1995-96, analysis of 1999 election data does not present a statistically significant negative relation between pro-government voting and transfers per capita (see Table 3.7). To test this hypothesis we applied a modified dependent variable: the differ-

[16] Some researchers (e.g. Popov, 2001; Delyagin, 2000) have claimed the opposite, but did not present satisfactory statistical evidence supporting their point of view.

ence in election results between pro-government election lists 'Our Home Russia (Nash Dom Rossiya)' in 1995 and 'Unity (Edinstvo)' in 1999. The amount of transfer disbursement in November-December 1999 and January-March 2000 served as the independent variables[17].

3.6. Some conclusions

The preceding analysis allows us to draw the following conclusions:

Firstly, high and firm electoral support for a pro-reformist coalition is a key condition for successful transition to a market economy. Both the international and the regional models have demonstrated the greatest importance of voting for pro-reform parties, the duration of their control over legislative and executive branches of government, etc.

Secondly, the outcome of the first free election ('constituent' election) significantly determines subsequent electoral behavior; this outcome is somewhat independent of the initial economic situation.

Thirdly, basic institutions of human rights (personal immunity, court guarantees against confiscation or arrest, freedom of press and religion, private property) can affect business risk evaluation more significantly than taxation, entrepreneurial legislation, etc, especially for the small business sector. This conclusion permits us to specify the set of institutions that are crucial for successful reform. It also underlines the importance of political reforms for the success of economic reforms.

In countries and regions that have carried out a successful transition (illustrated in our models by GDP dynamics or other income/wealth indicators) demand for classical institutions of a society based on the rule of law proposed by pro-reform parties and leaders is substantially higher than in countries/regions that have failed to emerge from post-totalitarian recession. They relate to such basic market/democratic institutions as civil liberties, property rights protection and effective contract enforcement.

Fourthly, as income and consumption dynamics can affect electoral behavior, election outcomes can be more or less influenced by a conscious redistributive policy. This means that a political business cycle approach (see Nordhaus, 1975) is a reasonable way to organize and support a pro-reformist coalition in transition societies. It also means that political compromises have clear limits in terms of their rationality. If reformers are forced to support anti-reform constituencies (for any reason) it will only further deteriorate their position.

[17] We could not use data for 1999 as a whole because the election block 'Unity' was formed just a few months before the December 1999 Duma elections and first three quarters of 1999 were characterized by a high level of political instability and uncertainty about the future political map of Russia. So we assumed that regional governors who supported 'Unity' had a choice: either believe in the Kremlin's promises of future transfers and push local administration structures to support this list or join an alternative 'list of governors' – 'Fatherland – All Russia (Otechestvo – Vsya Rossiya)' headed by ex-Prime-Minister Primakov and Moscow mayor Luzhkov. Thus, November-December 1999 and Q1 2000 transfer data may relevant for our goal of testing the ability of the federal government to build electoral support by means of fiscal redistribution to loyal governors.

4. External leveraging of Russia's reforms: the role of the IMF, the World Bank and the G7 countries

4.1. The overall picture

In the 1990s, financial flows into Russia can be divided into three periods in terms of their size and source. In the first period, 1992-1993, external official assistance, mostly from G7 countries, official and private debt relief, including deferral or cancellation of arrears and to lesser extent financing from the IMF dominated (see Table 4.1). The total net official financial assistance in 1992-93 accounted for over 4% (nearly 8% if official debt relief is included) of Russia's GDP[18].

During 1994-1996 the major role in conditional financing to Russia was played by international financial organizations (IFIs), mostly the IMF and World Bank. However, the size of official government financing to Russia increased by half, mostly as a result of the German contribution to the G7 financing. Finally, in 1997-98, progress in transition, together with explicit or implicit official guarantees, attracted private capital inflows in the form both of portfolio investment and foreign direct investment. Nevertheless, financing from G7 countries was similar to IMF or private flows. The crisis of 1998 and default on debts virtually halted the inflow of official and private financing to Russia.

During 1992-93, Russia received a total of approximately USD 62 billion of external financing (Citrin and Lahiri, 1995, Table 1.8), during 1994-96 ca. USD 66 billion and during 1997-98 ca. USD 62 billion (Kapur and Mensbrugghe, 1997). About 51% in 1992-93, 58% in 1994-96 and 18% in 1997-98 of total external financing took the form of rescheduling of debt and arrears towards rest of the world. Official lending (apart from the IMF) and grants accounted for an estimated 28% of total financing.

[18] By historical comparison, the USD13 billion provided by the US to Western Europe in 1948-1951 under the Marshall Plan, mostly in the form of foodstuffs and raw materials, of which a significant part was military surpluses or industrial inventories, was equivalent to an annual average of 2.5% of European GDP. Indeed, Marshall Plan assistance was mainly on grant terms, while most official financing to FSU consisted of loans.

With net disbursements of USD 22.1 billion Germany was the single largest contributor, representing 12% of total external financing received by Russia in the period 1992-98[19]. Germany was followed by the IMF, which contributed USD 14.5 billion (8% of total external financing), and by the World Bank, with USD 6.5 billion (3.4% of total financing). The United States took fourth place, with USD 4.4 billion, only 2.3% of total financing received in the period of 1992-98. The peak of official government financing come over the first two periods and amounted to 38% in 1992-1993 and 32% of total financing in 1994-1996. IFI financing reached its highest level in the second and third periods, amounting to 14% of total financing both in 1994-1996 and 1997-1998.

4.2. Some motivation of lending to Russia

Apart from the very political will to support Russia's transition to democracy and market economy other additional circumstances encouraged Western creditor/donor interest in providing financial aid to Russia and the Russian authorities' interest in resorting to this source of support.

At the beginning of transition, Russia was the main creditor to most FSU countries and extended trade credits to facilitate the maintenance of trade and production links. The threat of collapse of the ruble area made G7 governments and IFI experts reluctant to accept any radical disruption of payment mechanisms in the territory of the FSU, therefore accepting both the financial costs borne by Russia in the early phase of transition and the financial implications for Western creditors. Analyses of Russia's public expenditure record indicate that most spending, irrespective of how it was financed, was for current rather than capital purposes, including the settlement of arrears on wages and pensions. As such, the governments of G7 countries, facing an unprecedented political and economic challenge, agreed that "*saving Russia from communism matters more than the niceties of monthly bookkeeping*" (The Economist, 1996) and accepted massive and unconditional financing of Russia's transition.

Later on, as a result of substantial and prolonged GDP decline (cumulatively of over 35% in 1991-1994 and an additional 11% in 1995-1998), there was a sharp fall in government revenues that, combined with pressure to maintain spending levels, resulted in very high general government deficits of over 18% of GDP in 1992, 7.4% of GDP in 1993 and 10.4% of GDP in 1994. The usual response of governments in the early years of transition was to finance budget deficits by central bank credits, but the experience of hyperinflation or high and persistent inflation, combined with an abundance of external financing, persuaded the authorities to rely on foreign assistance and domestic non-monetary financing.

[19] A significant part of German aid was connected with the redeployment of Russian troops stationing on the territory of the former GDR.

Official external assistance and borrowing abroad appeared cheaper in the short term than borrowing from domestic financial markets, and longer maturities have been available on foreign loans. The financial needs of Russian governments have been matched by the willingness of both the IFIs and private companies to lend, at least until the last quarter of 1997. On the creditor side, the initial perception was that Russia had lower external indebtedness than most developing and transition economies (slightly over 22% in 1996). More importantly, substantial margins could be achieved on Russian Treasury papers relative to traditional sovereign borrowers, while medium-term bond yields in many traditional markets have either stabilized at relatively low levels or fell in the mid-1990s.

4.3. The role of the IMF

The IMF was the most important IFI in the first stage of the transition (Dabrowski, 1998; Gomulka, 1995) acting on behalf of the donor countries, particularly those belonging to the G7. This can be explained by the organization's significant experience not only in macroeconomic policy but also in structural and institutional reforms. IMF support to Russia started with the Stand-By Agreement (SBA) in June 1992, followed by two Structural Transformation Facility (STF) tranches (see Table 4.2).

Table 4.2. IMF facilities for Russia, 1992-2000

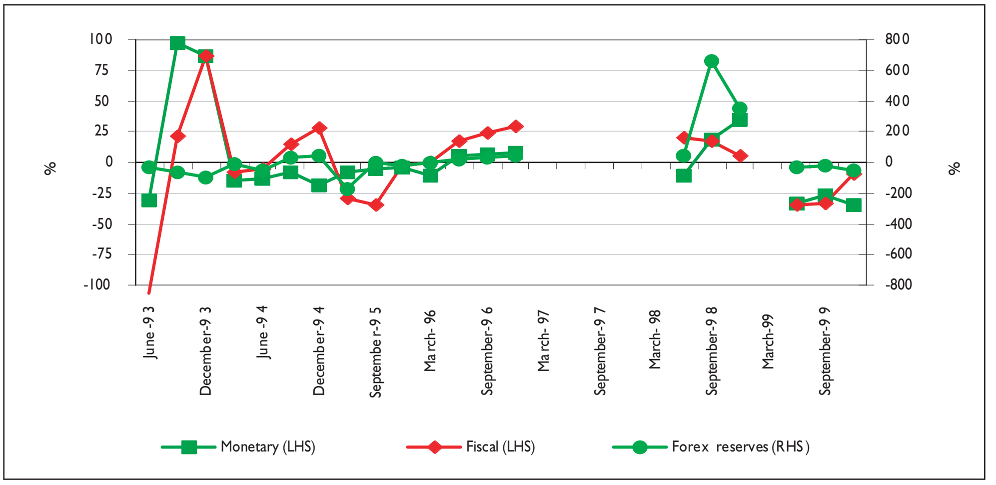
Year	1992	1993	1994	1995	1996	1997	1998	1999	2000
Type of program	SBA		STF	STF	SBA		EFF		SBA

Sources: www.imf.org.

The first 1992 SBA did not involve strict conditionality. The same went for the STF, which was a financing facility of limited size specially designed for transition economies under severe trade and payment disruptions (between 1993 and 1995). Performance criteria were loose, with fiscal deficits of up to 10% of GDP permitted (Dabrowski, 1998).

On June 30, 1993, the IMF Executive Board approved an economic program to be supported by a two-tranche purchase under the STF. Russia purchased the first tranche of SDR 1,078.3 million (equivalents to 25% of the quota) from the IMF on July 6, 1993. The STF, as a brand-new IMF facility, made it possible to credit the new Russian government irrespective of the failure of the SBA in 1992. Also, the STF purchase from the IMF would not have to be added to the stock of Russia's official international reserves but would be available to provide additional credit to the economy (and to the budget). The program got off to a good start, but as early as the third and the fourth quarters of 1993 targets were exceeded by wide margins (Figure 4.1) However, this did not result in a halt in the funding (see Figure 4.2).

Figure 4.1. Russia's compliance with IMF quantitative monetary, fiscal, and exchange rate targets in 1993-1999 (in %)



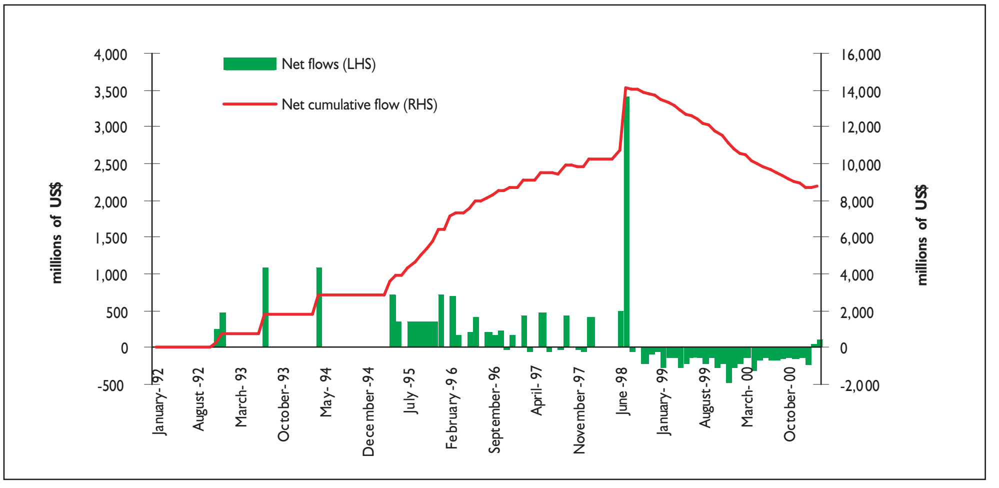
Note: Exceeding targets should be viewed as non-compliance with conditionality. Targets are equally weighted.
Source: IMF (A4C, IFS, RED, SP).

On April 20, 1994, the second STF tranche of SDR 1,078.3 million was approved. The major goal of the program was to safeguard the fragile achievements of the hitherto reforms, especially in the areas of price and exchange rate liberalization, and foster structural reforms, including mass privatization, foreign trade liberalization, increased competition and transparency.

In the second quarter of 1994 program implementation was on target. The monthly inflation rate fell to 6% in June and to 4.5% in August 1994. The government managed to keep its borrowing from the CBR within the program targets, though mainly through aggressive sequestration of expenditures as budget revenues collapsed. In the third quarter, however, CBR credit surged as revenues fell in relation to GDP and subsidies to the agricultural sector, the Northern Territories and other customary recipients of budget support rose sharply. The government's ability to use sequestration diminished and parliament rejected most of the revenue measures specified in the second STF. In mid-1994, the authorities ran down official reserves in an attempt to offset increasing net credit to the government. After international reserves dropped by almost USD 4 billion in the third quarter of 1994, foreign exchange market participants started to speculate against the ruble. On October 11, 1994 ('Black Tuesday'), the ruble tumbled on the Moscow inter-bank market by over 20% against the USD.

In the fourth quarter of 1994, the central bank limited credit expansion to banks and the government and Ministry of Finance restricted expenditures and started issuing government securities. The credit contraction led to a rise in interest rates, but inflation continued to increase, reaching a monthly rate of 16% in December 1994 – twice the STF projection. Fiscal targets were exceeded by wide margins, the stock of international reserves dropped

Figure 4.2. IMF net disbursements to Russia in 1992-2001 (millions of USD)



Source: www.imf.org

below the target, the exchange rate depreciated by 45% during the second half of 1994 and the majority of liberalization measures were not implemented. The second STF had failed as completely as its predecessor.

As in previous years, a major tightening of monetary and fiscal policies took place at the beginning of 1995. In January, the stock of credit to the government was frozen, the CBR increased reserve requirements, and – as international reserves kept declining – the monetary base shrank by 9%. Inflation slowed to 10-11% in February-March. On March 10, 1995, in a letter to the IMF's Managing Director Michel Camdessus, President Boris Yeltsin expressed his support for the new program. On April 11, 1995, the IMF Executive Board approved the SBA support of SDR 4,313.1 million for a period of 12 months. According to official statements, the SBA was aimed at decisive progress in stabilization and structural reform during 1995 and envisaged the same measures as in the previous programs, both from the macroeconomic and structural perspectives.

In the course of the SBA quantitative targets were all met month by month by comfortable margins. The most vulnerable situation remained in the fiscal sector because of the substantial revenue shortfalls that persisted throughout 1995. Measures to improve revenues were implemented only partially or with a lag. The main revenue categories barely exceeded the program's projections in nominal terms in spite of substantially higher inflation, and for 1995 the ratio of revenue to GDP turned out to be nearly 3 percentage points below the programmed level. Under these circumstances, in order to meet the deficit target, the authorities contained spending (in relation to GDP), keeping it below programmed levels.

On the monetary side, while domestic credit targets were met, large capital inflows put pressure on the ruble, leading to nominal and real appreciation and/or growth in the monetary base (given the limited capacity for sterilization). Growing confidence in the ruble and an increase in reserves made possible the introduction of an exchange rate band on July 5, 1995 (4,300 – 4,900 rubles per 1 USD). However, in the second half of October, pre-election pressure became evident and fiscal policy started to drift away from the targets. The previously accumulated margins allowed the targets for October and November to be met. In December (especially in the last ten days of the month), the authorities probably used 'window dressing' to meet the targets.

Structural reforms, especially bank restructuring, were relatively sluggish. This became evident when an inter-bank liquidity crisis emerged toward the end of August 1995. The pace and scale of cash privatization fell short of expectations and the transparency of the whole process, due to the introduction of the 'loans-for-shares' scheme, was thrown into doubt. Finally, little progress was achieved in the area of land reform. Summing up, in 1995 the Russian authorities apparently decided to meet the macroeconomic targets but at expense of structural reforms that conflicted with the interests of various lobbies and were therefore politically difficult. The relative success of the 1995 SBA (in comparison with the performance of the previous arrangements) allowed the Russian authorities to request IMF support for the medium-term program of macroeconomic stabilization and structural reform.

In a letter dated March 6, 1996, the Russian government requested a three-year arrangement under the EFF to the tune of SDR 6,901 million, or 160% of the quota. The on-going stand-by program would then have to be cancelled as of the date of approval of the extended arrangement. This trade-off yielded positive results: almost immediately, on March 26, 1996, the IMF Board approved the program.

The proposed strategy for 1996-1998 was aimed at establishing a foundation for sustainable growth by lowering inflation to a single-digit annual rate, implementing key structural reforms and achieving medium-term viability of the balance of payments. The 1996 program was based on reasonably optimistic forecasts, such as a high annual rate of GDP growth (6% starting from 1997), 1% monthly inflation as of the end of 1996, remonetization, repatriation of flight capital, an increase in FDI and a comprehensive restructuring of debt obligations (USD 7 billion). The huge debt service burden of the federal budget had already been seen in 1996.

However, a further reduction in a general government deficit from around 6% of GDP in 1995 to 4% of GDP in 1996 and 2% of GDP in 1998 was the critical element of the program. Local governments and off-budget funds were to balance their budgets or finance deficits from non-inflationary sources (without credits from the CBR). The net increase in revenues of close to 5 percentage points of GDP was to result from an increase in tax rates and a broadening of the tax base via the elimination of tax exemptions and preferential treatment, especially for fuel producers.

The monetary framework targeted the same parameters as previous programs, limiting the pace of credit expansion and monetization of the budget deficit. The programmed domestic assets expansion would not result in growth of the monetary base because it was exactly offset by a decline in the monetary authorities' net international reserves. The same was true of the 1995 program – the sale or use of central bank foreign reserves was included as part of the monetary authorities' net credit to the federal and general governments. Therefore, the IMF's intention was clearly non-inflationary deficit financing.

The period 1996-1998 reflected a fragile and illusory macroeconomic stabilization. Since 1995 Russia had not been able to achieve its main fiscal policy objectives, which were a reduction in the unsustainably high deficit, a reversal in declining budget revenues and a reduction of expenditures. The general government primary deficit rose from 2.6% of GDP in 1995 to 3.1% of GDP in 1997 and the overall deficit increased from 6.1% to 7.7% of GDP in the same period. At the same time, general government revenues increased from 33.5% of GDP in 1995 to 35.5% of GDP in 1997 only, whereas expenditures increased from 39.6% to 43.2% of GDP in the same period. This reflected a number of fundamental factors but perhaps the most important among them was a continued recourse to non-monetary fiscal operations and tax offset schemes on the revenue side and expansion of interest payments on debt on the expenditure side.

In mid-1998, the accumulation of macro- and microeconomic problems coincided with cumulating maturity of debt payments due in the third quarter of 1998, amounting to one third of budget revenues and a current account deficit resulting from a decline in world oil prices. Moreover, the Asian crisis in 1997-1998 had increased financial market volatility and investor pessimism about the performance of the Russian economy.

Some adjustment measures proposed by the government of Prime Minister Sergei Kiriyenko, especially sequestration of expenditures and proposed changes in tax law, did not find support in the Duma. Capital flows remained volatile and market confidence was not restored. On July 16, 1998, a Memorandum on Economic and Financial Stabilization Policies was signed between the Russian authorities and the IMF. The government program was basically identical to those supported by the IMF but which had not been implemented over the previous five years. It aimed at radically tightening the federal budget and lengthening debt maturity. The authorities expected 'substantial foreign financing' of the program.

The proposed package of measures for 1998 was partially based on the on-going EFF arrangement. However, the Duma rejected the proposed changes in tax policy (broadening the base of Personal Income Tax and transferring a higher share of PIT revenues to the federal budget, increasing the land tax and balancing the budget of the Pension Fund). The Russian government had to provide a supplementary memorandum to the IMF on July 20. On July 31, the IMF tried to avert crisis by disbursing a SDR 3.4 billion tranche. However, this in fact only hastened the inevitable deep correction of the exchange rate which had been made necessary by accumulated macroeconomic imbalances.

With the crisis of August 1998, Russia breached all quantitative targets established in the EFF program. IMF disbursements to Russia came to a halt. The next program, the SBA for

SDR 3.3 billion (55.5% of quota) for a period of 17 months, was signed on July 28, 1999. Through the end of 2000 Russia made only one purchase. Quantitative performance criteria for the end of July, the end of September and the end of December 1999 were reached (many with large margins). However, there were also many shortfalls relative to structural benchmarks for the third and fourth quarters of 1999.

As IMF disbursements in the first-generation programs (i.e. STF and SBA) may have been attributable to soft conditionality and the political commitments of G-7 governments, the failure of the second-generation programs (EFF) was proof of a certain myopia in the Fund's approach that perceived short-term macroeconomic stabilization as a sign of its long-term sustainability. If the Russian authorities were prepared to follow the path of responsible policies, external binding commitments could give them an additional political instrument. However, there were four main group of factors that determined the failure of the IMF stabilization policy in Russia: (1) Unrealistic assumptions concerning GDP growth, exports, and budget revenues led to formulation of stabilization programs that were sustainable only if these assumptions were realized. (2) Lax conditionality undermined macroeconomic discipline, while (3) improved access to non-inflationary sources of deficit financing was a source of accumulation of arrears and debt. Finally, (4) ineffective conditionality in the area of structural reforms stimulated only 'paper reforms' and not real restructuring of the economy (see Antczak, Markiewicz, and Radziwill, 2003).

4.4. The role of the World Bank

The World Bank's goal in Russia was to ease the structural transition from a planned to a market economy, avoid the geopolitical consequences of a policy reversal and minimize the human costs of the reforms (Zanini et al., 2002, p.37). In practice, the Bank's objectives were defined as: (1) restructuring of old enterprises, (2) the creation of new enterprises, (3) an

Table 4.3. World Bank lending to Russia, 1992-2002 (millions of USD)

Fiscal Year [a]	1992-95	1996	1997	1998	1999	2000	2001	Cancelled	Total
Rehabilitation loans	1 200	0	0	0	0	0	0	0	1 200
SALs (SECAL&SPAL)	0	500	1 400	1 600	1 500	0	0	1 100	3 900
Oil, gas, and energy	1 180	528	40	0	0	0	85	352	981
Social sectors	110	470	137	29	0	0	130	120	755
PSD/FSD/infrastructure	1 519	763	216	0	400	0	182	1 069	2 012
Agriculture/environment	529	80	0	0	0	60	226	118	777
Econ. public sector mgt	70	21	58	0	30	30	0	2	195
TOTAL	4 608	1 899	1 816	1 629	1 930	90	624	2 761	9 834
Disbursements	**729**	**981**	**2 086**	**2 172**	**657**	**606**	**605**		**7 836**

Note: a – fiscal year starts from July 1 of the previous calendar year
Source: Zanini et al. (2002), p. 41.

improved environment for investment and (4) reform of social protection. Average annual disbursements amounted to around USD 600 million from over USD 1 billion annual commitments to Russia during 1992-1998 (see Table 4.3).

World Bank aid focused mostly on structural projects which needed time to be prepared and implemented. This was the reason why during the first period of Russia's reforms in 1992-1993 only 4 projects were launched. However, in August 1992, at the request of the G7, and in parallel with the IMF, the SBA the World Bank approved USD 600 million of the Rehabilitation I Loan with virtually no conditionality. The Rehabilitation II Loan was postponed until mid-1995 by which time various trade reforms had been adopted and the IMF accepted the SBA for Russia (see Section 4.3).

A rapid expansion of lending took place during the years 1994-1996, with 24 projects launched and the Bank's commitments reaching over USD 1.5 billion annually. According to the assessment of the Operation Evaluation Department of the World Bank, over 60% of project commitments experienced serious implementation problems (see Zanini et al., 2002 for details) and from mid-1995 to early-1996 less than USD 30 million of new commitments were made by the Bank. In March 1996, the Bank came under pressure to join the IMF, which had approved the USD 10.1 billion EFF (see Section 4.3). This was clearly a manifestation of donors' desire of 'avoiding the geopolitical consequences of a policy reversal' four months before the July 1996 Presidential elections. Irrespective of technical difficulties, the Bank was able to move with investment and technical assistance programs worth USD 1.9 billion and targeted towards housing, capital markets development, legal reform, medical equipment, and coal sector adjustment.

The peak of the Bank's commitments came in the calendar year 1997, with projects amounting to USD 3.4 billion followed by peak disbursement of USD 2.2 billion in 1998 (see Table 4.3). The formation of the government of 'young reformers' (see Chapter 2) was seen as a window of opportunity for structural reforms. Adjustment lending amounted to USD 3 billion and involved Structural Adjustment Loans I and II (with conditionality related, among other things, to tax reform, elimination of budget arrears, case-by-case privatizations, restructuring of power, natural gas, and railways sectors and banking reform), the Social Protection Adjustment Loan and the Coal Sector Adjustment Loan (SECAL II).

The loan conditions were mild and mostly related to preparatory reform steps such as drafting or submission of legislation to the Duma rather than adoption of legislation, its enforcement and implementation. Furthermore, most were not really fulfilled. However, both the IMF and World bank granted Russia a not fully justified 'seal of good housekeeping' that opened the door to bilateral donor and private financing. This stamp of approval led to upgrading Russia's international ratings and very significant capital inflows.

After the appointment of the Kiriyenko government in April 1998 the World Bank and IMF were called on by the G7 to contribute around USD 6 billion to the emergency financial package aimed at strengthening confidence in the ruble. The Bank responded by accelerating the processing of the USD 1.5 billion SAL III. However, its disbursement was limited to the first tranche of USD 300 million in July 1998 and one small tranche of USD 100 million in mid-1999, following the loan's restructuring. The 1998 crisis adversely affected many of the Bank's projects and led to halt in substantial financing. During 1999-2000, the Bank focused on social protection, education, health care and municipal programs.

4.5. The role of the G7

The interest of the major industrial democracies in supporting the political and economic transition in the former Soviet Union started from the 1990 Houston Summit, where the Group of Seven (G-7) leaders ordered a joint OECD/IMF/World Bank/EBRD 'Study of the Soviet Economy', which was published a year later. Beyond the very general G7 commitments to the Soviet Union and Russia at Houston (see Table 4.4), German Chancellor Helmut Kohl for the first time called for Soviet support to the unification of Germany. The French President Francois Mitterrand joined Kohl in calling for USD 15 billion in outright grants and loans to the Soviet Union, but other leaders disagreed. At first, President George Bush dismissed the idea of giving assistance to the Soviet Union, then eventually joined the position of UK Prime Minister Margaret Thatcher who insisted the aid be conditional on economic and political reform.

Table 4.4. The G-7 commitments to Russia

Year and place of summit	Total number of Commitments	Commitments on Russia or related to Russia		
		G7 / G8 Communiqué	Political Declarations	Sum / % of total
1990, Houston, U.S	78	3	1	4 / 5%
1991, London, UK	53	1		1 / 2%
1992, Munich, Germany	41	12	6	18 / 44%
1993, Tokyo, Japan	29	8		8 / 28%
1994, Naples, Italy	53	3	1	4 / 8%
1995, Halifax Canada	78		1	1 / 1%
1996, Lyon, France	128		3	3 / 2%
1997, Denver, U.S.	145	6 / 2		8 / 6%
1998, Birmingham, UK	73			0 / 0%
1999, Köln, Germany	46			0 / 0%
2000, Okinawa, Japan	105			0 / 0%
2001, Genoa, Italy	58			0 / 0%
2002, Kananaskis, Canada	187	0 / 6		6 / 3%

Note: The commitments identified are taken from all documents issued publicly by the G7/8 at its annual summits, from 1990 to 2002. These documents include summit communiqués, statements from the chair and political, economic and miscellaneous declarations by the G7/8. They exclude reports to the summit leaders or documents issued at the summit by other G8 groups or larger dialogue groups.
Source: Kirton et al. (2003).

During the 1991 London Summit the Soviet President Mikhail Gorbachev was invited to have a lunch with G-7 leaders. The G7 and US President George Bush proposed the Soviet Union become 'a special associate' of the IMF and the World Bank. In addition, the Soviet Union would get agricultural credit guarantees of USD 1.5 billion.

Developments in the former Soviet Union at the end of 1991 and early 1992 were beyond the G7's expectations. Therefore, the Munich Summit in 1992 was dominated by problems created by the collapse of USSR and over 44% of all commitments were related directly or indirectly to Russia. Attention was mainly focused on preventing the transfer of scientists and proliferation of nuclear capacities from the former Soviet Union to other countries and the G7 made its first offer to FSU countries, including Russia, to finance guaranteeing the safety of their nuclear programs. The G7 proposed USD 24 billion of financial aid for Russia, from which USD 6 billion was to be set aside to stabilize the Russian ruble (following the positive example of USD 1-billion stabilization fund established for the Polish zloty in January 1990), while USD 18 billion was earmarked for economic restructuring. Most of the declared aid was never concretely committed and disbursed. In June 1992 the Russian Federation joined the IMF and the World Bank, resulting in the SBA and Rehabilitation Loan (see Section 4.3).

The summit in Tokyo in 1993 added some aid declarations. G7 conditionality did not go beyond those of the IMF and World Bank and insisted on control of Russia's budget deficit and money supply. Prices, including energy prices, also had to be fully freed. There also had to be firmer guarantees for private property rights, while all republics of the former Soviet Union had to show leadership in dismantling trade barriers between one another. The same kind of recommendations and conditionality were given by the IMF under the STF programs.

During the 1994 summit in Naples the G-7 offered Russia the perspective of GATT membership. During the next summit in Halifax the issues of dismantling nuclear weapons that had been initiated under START I and ensuring control over fissile material from nuclear weapons and reactors were the main topics raised by the US and other G7 countries. The G7 also insisted on nuclear disarmament and safety in Russia at the Lyon Summit in 1996.

In 1997, at the Denver Summit Russia was granted non-full member status and effectively the G7 became the G8 at the subsequent two summits. Russia's membership of the G8 was strongly advocated by US President Bill Clinton as compensation for NATO's expansion eastward and also as a final legalization of its discretional presence at G7 summits since 1991. After the Denver Summit, the goal of bringing Russia into international organizations such as the Paris Club, WTO and OECD was also expressed by the G7, together with its strong insistence on Russia's active participation in nuclear safety and security programs.

The 1998 financial crisis in Russia came as an unexpected and unpleasant surprise for the G7, given its deep engagement in preventing such a course of events. During 1997-1998 total external financing to Russia amounted to USD 61.7 billion, a level similar to 1992-1993, and relatively higher than during 1994-1996. The G7 made over 90% (USD 6.5 billion) of bilateral official financing, with Germany's contribution amounting to 80% (USD 5.2 billion) of the overall G7 share (see Table 4.5). IMF and the World Bank financing was USD 8.9 billion combined. FDIs and other (short term financial) investments, as well as debt relief, reached a record high of USD 42.7 billion.

Overall during the period 1992-1998 Russia received USD 189,250 million in total financing, of which USD 41,507 million (22% of total financing) was in bilateral official assistance, with USD 31,978 million (17% of total) coming from the G7 and Germany as the largest contributor with over USD 22 billion (12% of the total). The IMF and the World Bank combined contributed USD 20,930 million (over 11% of the total). Investments to Russia, direct and portfolio, both reached over USD 15 billion in 1992-1998.

However, the largest financing resulted from debt relief and arrears towards ROW to the sum of USD 81,500 million (43% of total financing). The exact disaggregation of this item between debt relief and arrears of sovereign governments and public and private companies is difficult due to the lack of reliable data and low transparency of bilateral and multilateral deals. One can assume that the G7 contributed to the lion's share of it.

Table 4.1. Gross financial flows into Russia, 1992-1998 (millions of USD)

Years	Loans					Grants	Debt relief		Arrears ROW	Debt relief &arrears [4]	FDI	Other [5]	FSU financing	Total financing
	EU	EBRD	IBRD	IMF	Official ROW [1]		Private [2]	Official [3]						
1992-3	341	100	400	2 541	17 900	5 800	11 500	14 000	6 000	31 500	2 200	500	300	61 582
1994-6	154	747	2 203	6 901	16 428	4 586	-	-	-	39 000	5 334	-9 448	-	65 905
1997-8	245	936	3 851	5 034	7 179	1 790	-	-	-	11 000	7 628	24 100	-	61 763
Total	*740*	*1 783*	*6 454*	*14 476*	*41 507*	*12 176*	*11 500*	*14 000*	*6 000*	*81 500*	*15 162*	*15 152*	*300*	***189 250***

Notes: [1] ROW includes all countries other than FSU countries.
2 Private debt relief includes deferrals and rescheduling by suppliers.
3 Official debt relief includes Paris Club rescheduling, deferrals, and rescheduling by other creditors including Kuwait and Saudi Arabia
4 Debt relief & arrears sums up debt relief and arrears
5 Other financing is composed of private short-term capital flows
Source: OECD MAXDATA Statistical Compendium 1#2003; IFS IMF April 2003; IMF Country Reports.

Table 4.5. Gross official flows from the G7 into Russia, 1992-1998 (in USD millions and as a % of total financing)

Years	Total financing Mln	Germany		United States		Italy		Japan		Canada		United Kingdom		France	
		Mln	%	Mln	%	Mln	%	Mln	%	Mln	%	Mln	%	Mln	%
1992-1993	9 565	6 539	10.6	1 931	3.1	151	0.2	173	0.3	681	1.1	72	0.1	18	0.03
1994-1996	15 882	10 360	15.7	1 730	2.6	3 089	4.7	427	0.6	81	0.1	142	0.2	53	0.1
1997-1998	6 530	5 164	8.4	697	1.1	26	0.0	382	0.6	50	0.1	111	0.2	100	0.2
1992-1998	***31 978***	***22 063***	***11.7***	***4 358***	***2.3***	***3 267***	***1.7***	***982***	***0.5***	***812***	***0.4***	***325***	***0.2***	***171***	***0.1***

Source: OECD MAXDATA Statistical Compendium 1#2003

5. The Effects of Economic Reform in Russia

The aim of this chapter is to illustrate the outcomes of economic reforms in Russia with the help of statistical (quantitative) indices and qualitative (characterizing institutional changes) policy indicators, as well as to compare them with other transition countries. As shown in Chapter 2, the implementation of all the principal ingredients in the transition process, such as liberalization, macroeconomic stabilization, restructuring and privatization, legal and institutional reforms (see Fischer and Gelb, 1991), has been characterized by a great deal of inconsistency, which has in turn been one of the main reasons behind the slow pace of reform and its often contradictory results.

Thus, the claim that all socio-economic indicators at every stage of the transition process have evolved under the direct influence of the reforms per se would be incorrect. Instead, one can speak about the resultant vector of many unfinished and inconsistent (compared e.g. to the CEB countries) components of the reforms and the effects of many exogenous and endogenous factors.

We have chosen 1989-90, 1994-95, 1998-99 and 2002-2003 as the breaking points for our comparisons as they reflect periodization of the Russian reforms presented in Chapter 2[20].

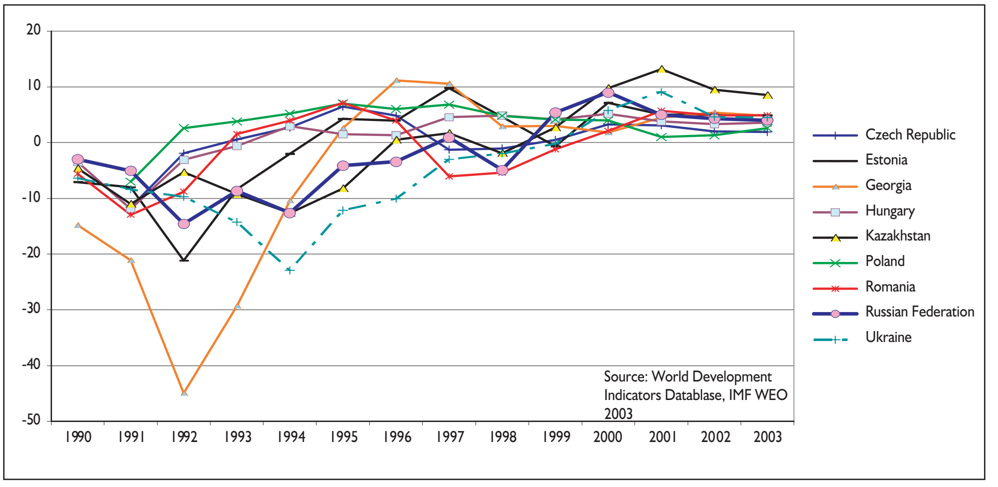
5.1. Macroeconomic developments

The transition period began with two great shocks: an output fall (see Figure 5.1) and a burst in inflation (see Figure 5.2).

According to Gaidar (1997; 2003a; 2003b), the major factors that determined the length and depth of the 'adaptation' output decline in Russia in 1990s (as distinct from many CEB countries) were: (i) a large share of production, which did not meet real market demand (but

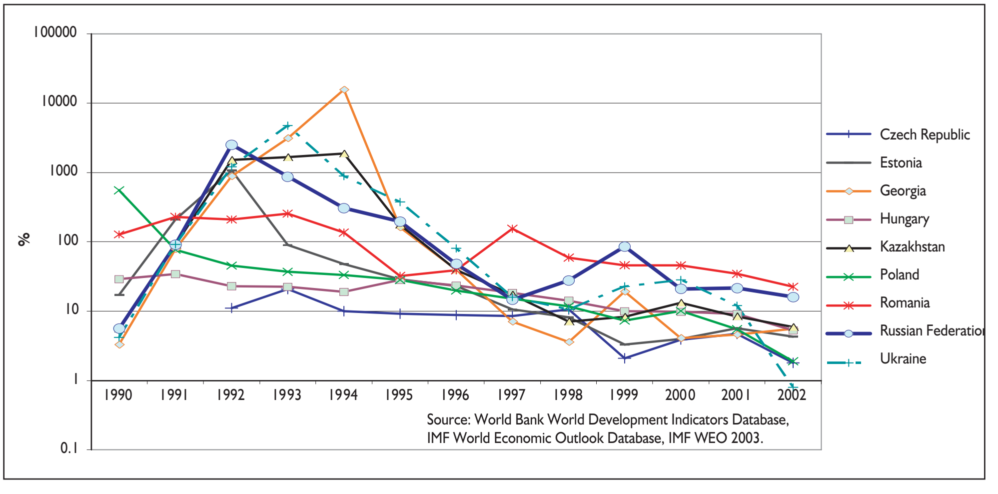
[20] Earlier comparative data, for example, for 1984 or 1985 illustrating the pre-Perestroika state of affairs are not available. Late-Soviet data (1989-1990) are also not always comparable with the later ones or their quality is doubtful. This is a standard problem in investigating growth trends in post-communist economies.

Figure 5.1. GDP (constant 1995 USD), annual % change



instead was determined by a centralized state planning system, primarily in military-industrial complex); (ii) minimal use of market instruments under a communist regime; (iii) a complete loss of skills to work under market conditions.

Figure 5.2. Inflation, consumer prices (annual %)



Apart from these unfavorable starting conditions, development trends throughout this period were determined by the slow pace and non-optimal sequencing of the reforms themselves. Slow pace and inconsistency of macroeconomic stabilization and fiscal adjustment hampered structural and institutional changes, which in turn prolonged the period of deep output decline in Russia (the over 40% output fall lasted for 8 years!). Positive growth dynamics, accompanied by macroeconomic stabilization, did not start until 1997 and in 1998 Russia was again thrown into financial crisis.

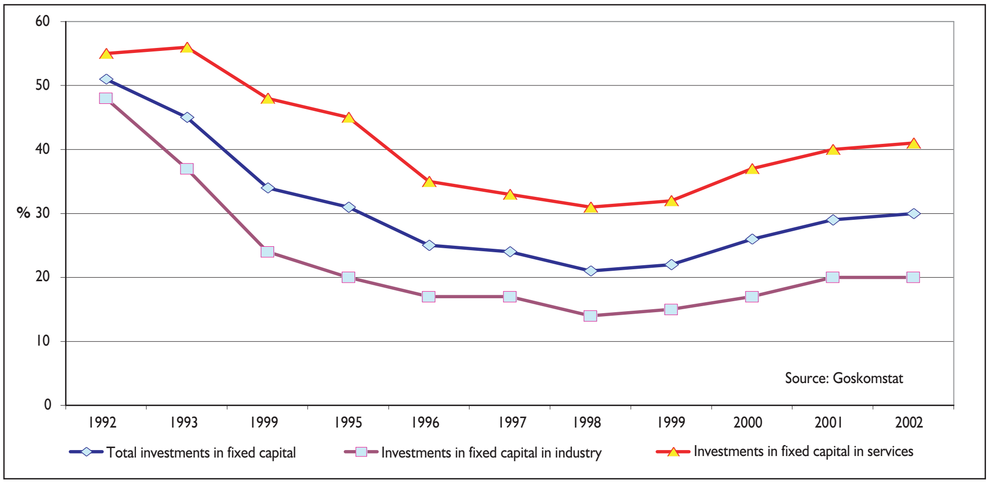
As opposed to Russia, comprehensive and consistent reforms in CEB countries have allowed the duration of 'adaptation' output decline to be reduced, although in some it still appeared to be rather deep (for example in the Baltic countries). However, one should keep in mind all the methodological risks involved in cross-country comparative analyzes of growth records[21].

Comparisons with other countries show that progress in macroeconomic stabilization (especially lowering inflation) became a key basis for any subsequent output recovery. Countries that managed to tame inflation quickly tended to experience a speedier and stronger recovery in output (see e.g. IMF, 2000). Moreover, in many CEB countries the early success of economic stabilization helped strengthen the constituency in favor of further reforms, both political and economic. In Russia, though, economic growth was delayed and the country has found itself in slow reform equilibrium mode for several years now.

High growth rates in Russia starting from 2000 can be explained by: (1) the depth of the previous output decline and use of simple reserves (e.g., utilization of idle capacities); (2) the positive effects of economic reforms conducted in the 1990s (particularly privatization), and (3) high oil prices on international markets (see Dabrowski, 2003).

Further economic growth will be determined, however, by more sophisticated factors, including investment dynamics. In Russia, the average annual growth rate of gross domestic investment during 1991-2001 was negative, amounting to -14.6%. The situation changed

Figure 5.3. Volume indices of investments in fixed capital in Russia (1990=100)



[21] Some problems with the pre-transition GDP statistics (for example, low utility and quality of final output, limited consumer choice, distorted prices and exchange rates, over-reporting of output under the communist regime) were far more severe in the former Soviet Union than in some Central European countries.

only in 1999 and positive growth rates were achieved in 2000-01 (+18.6% and +17.0%, respectively – see Figure 5.3).

Table 5.1. FDI in transition countries, 2002 (cumulative, USD M)

Country/ Region	Total, USD M	Per capita (USD)
Czech Republic	37 000	3 603
Slovakia	10 000	1 859
Hungary	27 000	2 659
Poland	46 000	1 191
Slovenia	5 500	2 754
Central Europe	**125 500**	**1 890**
Bulgaria	4 400	564
Romania	8 600	383
Croatia	7 700	1 738
South-East Europe	**24 900**	**476**
Estonia	3 600	2 647
Latvia	3 000	1 282
Lithuania	3 600	1 040
Baltic countries	**10 200**	**1 425**
Russia	25 000	174
Ukraine	5 000	104
Belarus	1 400	140
Moldova	700	193
European CIS	**32 100**	**156**

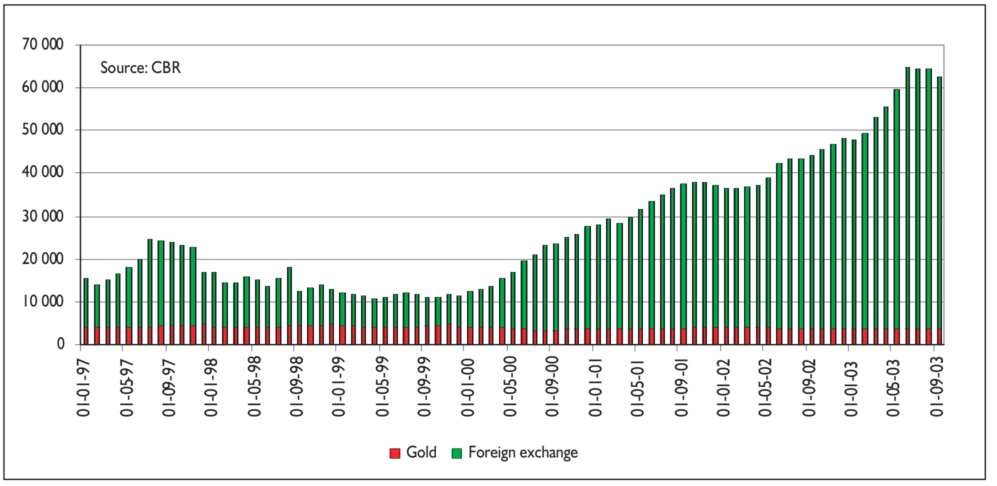
Source: WIIW-WIFO Database.

As distinct from CEB countries, which solved the problem of the domestic savings deficit by attracting FDI, Russia has a far from impressive record in this sphere (see Table 5.1) mostly due to its poor investment climate. Moreover, in all the transition periods Russia suffered substantial capital outflows (see e.g. Loungani and Mauro, 2000; Buiter and Szegvari, 2002).

In spite of progress made in fighting inflation its rate has remained higher compared not only to industrially developed economies, but to other transition economies as well. Among the latter, Russia ranked 22nd in 2001, ahead of only Belarus, Romania and Uzbekistan.

Up to 1999 fiscal policy (see Figure 2.1 in Chapter 2) could be blamed as the key factor responsible for the failure to bring inflation down to a low, i.e. single-digit, level. In 2000-03, as the fiscal situation radically improved inflationary pressures started to be generated from the huge balance of payments surplus and rapid increase in the CBR's foreign assets (Dabrowski, Paczynski and Rawdanowicz, 2002). In 2000, CBR gross foreign exchange reserves increased to USD 19.1 billion (from USD 9.4 billion in 1999), while the monetary base grew 1.5-fold. By mid-2003, foreign exchange reserves had grown to USD 64.9 billion (see Figure 5.4).

Figure 5.4. The CBR's gold and foreign exchange reserves, 1997-2003 (million USD)

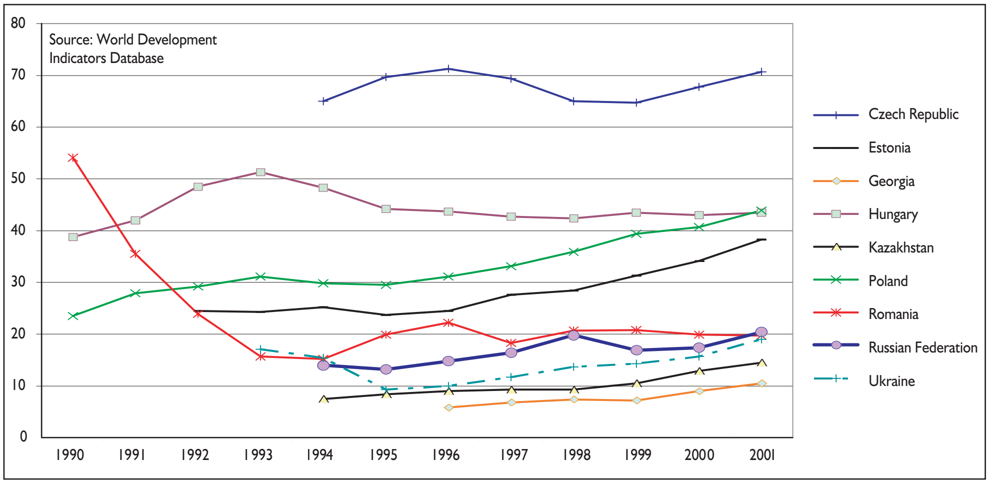


Source: Central Bank of Russia www.cbr.ru;

The level of monetization has also remained low throughout the transition period, reaching 20% of GDP only by the end of 2001 (see Figure 5.5 for comparison with other countries).

Generally, developments in monetary and fiscal policy spheres gave a picture of delayed stabilization in Russia and reminded developments in Latin America after the World War II (Gaidar et al., 1998, Chapter 6, p. 242). The lack of sufficient macroeconomic stability had also its unfavorable microeconomic equivalent: soft budget constraints, budget, tax, wage and pension arrears, netting-out operations, proliferation of money surrogates, widespread barter practices, dollarization, and expansion of unregistered economy. According to estimates of Johnson, Kaufmann and Shleifer (1997), unofficial economy represented 42% of GDP in Russia, 49% in Ukraine, and over 60% in Azerbaijan and Georgia in 1995.

Figure 5.5. Money and quasi money (M2) as a % of GDP



After the 1998 crisis, however, the scale of these phenomena decreased. The total volume of overdue arrears declined from 53.2% of GDP in 1997 to 48.6% of GDP in 1998 and 18.8% of GDP in 2000. The volume of barter transactions and mutual clearing shrank from 64.7% of total sales in 1998 to 36.8% in 2000 (Yasin, 2003, p. 295). According to 'Russian Economic Barometer' estimates, by October 2001 barter volume had decreased to 13% of total sales.

5.2. Structural changes in the economy

Industry was the major 'losing' sector during the 'adaptation' output decline period, with a cumulative fall of ca. 60% (this was in large measure the consequence of the over-industrialization of the Soviet period). In machine building, output decreased by over 70% (this also included military industry). In light industry, output in October 1998 amounted to 8.8% of the January 1990 level. The manufacture of certain industrial products fell more than tenfold in 1990-2001: the share of military production, conservatively estimated at 40% of GDP in 1990, declined six-fold in 1990-96 alone (see Yasin, 2003, pp. 417- 423).

In agriculture, harvested areas decreased from 112.1 to 82.8 million hectares, cattle stock declined more than two-fold – from 45.3 to 22.4 million, meat production (slaughter weight) fell from 10.1 to 5.3 million tons and milk production plummeted almost four-fold from 20.8 to 5.3 million tons.

Table 5.2. Changes in economic structure (value added, % of GDP)

Sector	1989	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Industry	50.2	41.3	42.9	42.5	39.2	36.7	34.1	36.2	35.5	39.0	37.3
Services	33.0	51.6	49.1	51.2	52.9	55.7	58.4	58.4	57.2	54.6	55.9
Agriculture	16.8	7.1	8.0	6.3	7.9	7.5	7.5	5.4	7.4	6.4	6.8

Source: World Development Indicators Database.

Table 5.3. Changes in economy structure (% of total employment)

Sector	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Industry	40.1	39.7	38.6	38.0	35.9	34.0	32.5	30.0	29.4	29.4
Services	41.0	41.5	41.2	46.1	47.7	50.0	52.2	57.8	59.1	58.8
Agriculture	13.9	14.2	15.4	15.5	16.1	15.7	..	12.2	11.5	11.8

Source: World Development Indicators Database

Similar to other post-communist countries, Russia witnessed profound changes in GDP structure in favor of services in its broad sense, including trade, transport, health, education, government services, etc. (see Table 5.2). Similar adjustments, albeit less abrupt, could also be observed in employment structure (see Table 5.3).

5.3. Social indicators

A drop in real registered incomes and an increase in income inequality between Russian households were the key social trends observed in the 1990s. Price increases surpassed growth in nominal wages and incomes, resulting in average real earnings falling by two thirds and real incomes by more than a half. Furthermore, the decline in wages and incomes continued until 1996, accompanied by an unprecedented increase in the non-payment of wages, pensions and social transfers[22]. After the 1998 crisis, real disposable incomes fell by another third and, as we can see from Table 5.4, their level remains far below pre-transition figures (despite an increase in real income in 2002-2003). However, one needs also to reflect that the pre-transition level of 'real' wages and incomes is not the best benchmark for comparison. Firstly, 'real' incomes/wages could hardly be called "real" in an environment of suppressed hyperinflation[23], an overall shortage of consumer goods and their low quality and limited consumer choice. Secondly, during the transition the unofficial economy exploded to a level of more than 40% of registered GDP (see Section 5.1) and became an important additional source of income.

Table 5.4. Real incomes of Russian society, 1992-2002, as a % of the previous year

Income category	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2002, % to 1991
Real disposable money incomes	52	116	113	85	101	106	84	88	112	108	109	60.5
Real accrued employee wages	67	71	92	72	106	105	87	78	121	120	116	40.1

Source: own calculations based on State Statistical Committee (Goskomstat) data.

Real income trends in CIS countries appear similar to those in Russia, whereas in the CEB countries positive growth rates of households' real incomes and expenditures had been mostly achieved already in the first half of the 1990s, and in some countries their level had even exceeded (or was approaching) pre-transition figures by 2000. In the Czech Republic, for example, the average real money wage in 2000 had reached 109.8% of the 1989 level; in Poland, Slovenia, Hungary and Slovakia these percentages amounted were 98.6%, 90.6%, 83.9% and 81.9%, respectively[24].

Social transfers are an important source of income for many Russians and are granted as cash allowances, payments in kind and subsidies to payments for services. Social transfers

[22] The volume of overdue indebtedness for wages, pensions and social allowances was equal to 3.22 billion rubles in 1994; 7.8 billion rubles in 1995; 45.5 billion rubles in 1996; 69.4 billion rubles in 1997; 123.2 billion rubles in 1998; 99.5 billion rubles in 1999; 66.3 billion rubles in 2000; and 54.9 billion rubles in 2001.

[23] Monetary overhang (forced savings) was estimated by Cottarelli and Blejer (1991) as close to 20% of GDP and one third of existing financial assets.

[24] TransMONEE Database 2000 and 2002.

paid in cash make up 13-15% of total income, of which 70-80% is allocated for pension payments. Cumulatively, they accounted for 5.2% of GDP in 1992, 7.5% of GDP in 1995, 9.9% of GDP in 1997 (the highest share), and gradually fell to 7.8% of GDP in 2000.

Table 5.5 shows the proportion of the 'Social policy' item in the total expenditures of the federal budget in 1995-2001. Prior to 1998, social policy expenditures accounted for 3-4 % of the federal budget; in 1998 their share in aggregate expenditure increased to 7% and remained at this level until 2000, when there was a further substantial increase in this item in 2001 (Maleva, 2002). One must take into account, however, the decreasing scale of federal budget expenditures in the 1990s (in real terms and in relation to GDP). This decreasing trend started to reverse in 2000.

Table 5.5. Share of the 'Social Policy' item in total federal budget expenditures, %

Year	Expenditure on 'Social policy' item	Including		
		Social aid	Pensions and allowances for servicemen and law enforcement employees	Other social policy measures
1995	4.19	3.23	-	0.96
1996	3.33	2.56	-	0.77
1997	3.37	2.6	-	0.77
1998	7.01	3.23	3.0	0.78
1999	7.28	3.2	3.36	0.72
2000	6.58	2.83	3.3	0.45
2001	9.24	3.57	3.75	1.92

Source: Maleva (2002), p. 11.

The leading reformers had a substantially larger share of social expenditures in the overall budget: it varied from one third of GDP (in Poland) to a quarter (in the Czech Republic, Slovakia and Hungary). Moreover, at the first stage of reforms, as GDP declined, this share tended to grow. This fact, together with a rapid implementation of the stabilization program and positive GDP rates of growth, made a rapid reduction in 'social costs' possible in the first transition stage. Countries where stabilization and output recovery were delayed (like Russia) experienced a sharp and prolonged decline of their living standards.

As for public social services, health and education expenditures in Russia also exhibited unstable trends, as shown in Table 5.6:

Table 5.6. Budget expenditures on health care and education, 1992-2000, as a % of GDP

Year	1992	1993	1994	1994	1996	1997	1998	1999	2000
Health care and education expenditures	6	7.2	7.7	6.3	7.4	8.7	7.4	6.6	5.9

Source: EBRD (2002).

The market transformation also changed the structure of the labor force in all transition countries: the share of employed has declined and the share of unemployed has risen. Two broad patterns of labor market adjustment can be identified. The first, largely associated with the CIS and the countries of Southeastern Europe, involved a decline in employment significantly smaller than the massive collapse of output and labor demand. The adjustment took the form of lower real wages as well as the emergence of wage arrears and hidden unemployment. Labor moved to low-productivity services and subsistence agriculture. Alongside labor hoarding by enterprises, these sectors served as shock absorbers in view of the lack of a well-functioning social policy.

The second pattern, broadly prevalent in the CEB countries, saw employment decline alongside output. Job cuts were concentrated in existing enterprises, while job creation was to be found almost exclusively in new enterprises (World Bank, 2002, p. 30)

In Russia employment cuts in ineffective sectors/enterprises were slow (compared to output decline), leading to large-scale hidden unemployment and the growth of employment in the shadow economy. Hidden unemployment (e.g. on long, unpaid leave or reduced working hours) has been estimated at 8-25% of the economically active population . The shadow economy employs about 25 million people, including 7 million without any other job, and 18 million combining work in the formal and informal sectors. Russia is the regional leader in terms of hidden unemployment. This can helps explain the considerable difference between overall (ILO definition) and registered unemployment in Russia.

Figure 5.6. Total (ILO definition) and registered unemployment in Russia, as a % of the labor force

Source: State Statistical Committee (Goskomstat)

Similar to the majority of post-communist countries, Russia set out on its transition with one of the world's lowest levels of inequality. This reflected the ideologically driven pattern of income policy under communism and almost total absence of the private business activity. As such, growth in inequality was unavoidable but varied greatly across the region (Table 5.7). It has increased rapidly in most CIS countries – nearly doubling in 2-3 years. Today, Russia ranks among the world's leaders in terms of levels of inequality. In contrast to Russia and the CIS, the increase of the Gini coefficient in the CEB countries has been relatively modest. For example, in Hungary it increased from 0.21 in 1987 to only 0.25 a decade later. Even in the Czech Republic and Slovenia, where the growth in inequality has been more pronounced, the distribution of income remains fairly egalitarian.

Table 5.7. Transition countries: Gini coefficient of income per capita

Country/ Region	1987–90	1993–94	1996–98	2001
CEB	**0.23**	**0.29**	**0.33**	
Bulgaria	0.23	0.38	0.41	0.32
Croatia	0.36	Na	0.35	0.29
Czech Republic	0.19	0.23	0.25	na
Estonia	0.24	0.35	0.37	na
Hungary	0.21	0.23	0.25	na
Latvia	0.24	0.31	0.32	na
Lithuania	0.23	0.37	0.34	0.36[b]
Poland	0.28	0.28	0.33	na
Romania	0.23	0.29	0.30	0.30[b]
Slovenia	0.22	0.25	0.30	na
CIS[a]	**0.28**	**0.36**	**0.46**	
Armenia	0.27	Na	0.61	0.49[b]
Belarus	0.23	0.28	0.26	0.34[b]
Georgia	0.29	Na	0.43	0.39[b]
Kazakhstan	0.30	0.33	0.35	0.31
Kyrgyz Republic	0.31	0.55	0.47	0.47[b]
Moldova	0.27	Na	0.42	0.36
Russian Federation	0.26	0.48	0.47	0.46[b]
Tajikistan	0.28	Na	0.47	na
Turkmenistan	0.28	0.36	0.45	na
Ukraine	0.24	Na	0.47	0.46[b]

Notes: na – not available, a – median of countries with data, b – data for 2000.
Sources: World Bank (2000b); World Bank World Development Indicators Database; EBRD (2002).

Such a huge and fast rise in inequality in Russia can be explained by the slow and inconsequent liberalization and macroeconomic stabilization undertaken in the first years of the transition (see Chapter 2), which saw the state taken over in effect by narrow groups of vested interests who were largely able to adapt economic policy to meet their interests and expected benefits, in turn limiting competition and concentrating their economic power, often at a high social cost. As result, rent seeking and corruption, instead of fair and open competition, have become the main sources of business success (World Bank, 2000a; 2002; Gelb, Hillman, and Ursprung, 1995).

A more detailed analysis of differentiation and concentration of income in Russia (see Table 5.8) shows that the share of the poorest quintile group in the total income of households continued to fall up to 1996 and remained fairly stable over the subsequent six years.

Table 5.8. Coefficients of differentiation and concentration of income, 1991-2000 (total money income = 100)

Quintile	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	**2002**
First quintile (with lowest incomes)	11.9	6.0	5.8	5.3	5.5	6.2	5.9	6.2	6.1	5.8	5.9	**5.6**
Second quintile	15.8	11.6	11.1	10.2	10.2	10.7	10.2	10.4	10.4	10.4	10.4	**10.4**
Third quintile	18.8	17.6	16.7	15.2	15.0	15.1	14.1	14.8	14,7	15.1	15.0	**15.4**
Fourth quintile	22.8	26.5	24.8	23.0	22.4	21.6	21.6	21.2	20.9	21.9	21.7	**22.8**
Fifth quintile (with highest incomes)	30.7	38.3	41.6	46.3	46.9	46.4	47.5	47.6	47.9	46.8	47.0	**45.8**
Decile coefficient of differentiation	**4.5**	**8.0**	**11.2**	**15.1**	**13.5**	**13.0**	**14.4**	**13.8**	**14.5**	**13.9**	**14.0**	**14.0**

Source: State Statistical Committee (Goskomstat).

The shares of the second, third and fourth quintiles continued to fall over the whole period (from 57.4% to 46.4%). Thus, the financial position of middle-income groups (potential middle class members) deteriorated. At the same time, the income share of the top 20% (the most affluent part of the population) has risen to almost a half of the total.

All the transition countries recorded a sharp growth in the poverty rate. In Russia, the poverty peak of 1992-93 was due to price liberalization which resulted in a 40% decline in officially recorded personal real incomes. Another fall was experienced in 1999 as a consequence of the 1998 financial crisis. (see Table 5.9).

Table 5.9. Population with money incomes below minimum subsistence level

Item	**1992**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Million people	49.7	33,3	36.3	32,5	30.3	34.0	41.2	41.9	39.4	35.8
Percent of the total popul ation[1]	33.5	22,4	24.7	22,0	20.7	23.3	28.3	28.9	27.3	25.0
Annual % change	...	...	109.0	89.5	93.8	112.2	121.2	85.0	94.0	90.9

Note: [1] Methodology used to estimate the share of population with money incomes below subsistence level has repeatedly changed over time. Thus, the data above are hardly comparable. For instance, if we use the system of income estimation of 1992 (the number of persons registered as poor at that time was 33.5%), then in 1994 the share of population below the poverty line would have been 34% and in 2000 28%. However, if we consider incomes from the unofficial sector, then in 1994 the share of the poor shrinks to 22%, but grows to 29.9% in 1999 (see Maleva, 2002).
Source: State Statistical Committee (*Goskomstat*)

Among many composite indices of quality of life developed over the past two decades (see Booysen, 2002, for elaboration), the UNDP human development index (HDI) is by far the most widely used.

Providing a simple summary measure of three dimensions of human development (living a long and healthy life, being educated and having a decent standard of living), the index combines measures of life expectancy, school enrolment, literacy and GDP per capita to offer a broader view of a country's development than using income alone.

Table 5.10 demonstrates that, as opposed to Russia, where HDI value declined steadily in the period 1985-1995, the majority of CEB countries either increased or maintained HDI scores throughout the whole transition period.

Table 5.10. Human Development Index Trends 1985-2001

HDI Rank in 2001	Country	1985	1990	1995	2001
29	Slovenia	..	0.843	0.851	0.881
32	Czech Republic	..	0.835	0.843	0.861
35	Poland	..	0.794	0.81	0.841
38	Hungary	0.803	0.803	0.807	0.837
39	Slovakia	..	..	..	0.836
41	Estonia	0.818	0.814	0.793	0.833
45	Lithuania	..	0.819	0.785	0.824
50	Latvia	0.803	0.803	0.761	0.811
57	Bulgaria	0.79	0.792	0.784	0.795
63	Russia	0.811	0.809	0.766	0.779
72	Romania	0.782	0.768	0.765	0.773
75	Ukraine	..	0.797	0.748	0.766
76	Kazakhstan	..	0.781	0.738	0.765
88	Georgia	..	..	..	0.746
89	Azerbaijan	..	..	..	0.744
100	Armenia	..	0.756	0.709	0.729
102	Kyrgyzstan	..	..	..	0.727
108	Moldova,	0.739	0.756	0.704	0.7
113	Tajikistan	0.736	0.736	0.665	0.677

Source: HDR (2003).

5.4. Structural and institutional reforms

Corporatization and privatization in Russia were more rapid than in the majority of CEE and CIS countries. In 1999, the private sector in Russia produced about 70% of GDP as compared to 5% in the pre-transition period (see Table 5.11).

Table 5.11. Privatization results in selected CEE and CIS countries

Country/ region	Private sector share in GDP, %				Privatization		Corporate governance & structural reforms
	1990	1994	1999	Mid-2001	large	Small	
CIS	10	20	50	-			
Armenia	12	40	60	70	3+	4-	2+
Belarus	5	15	20	20	1	2	1
Russia	5	50	70	70	3+	4	2+
CEB	11	50	68	-			
Hungary	18	55	80	80	4	4+	3+
Romania	17	40	60	65	3+	4-	2
Czech Republic	12	65	80	80	4	4+	3+
Estonia	10	55	75	80	4	4+	3+

Source: EBRD (2002)

Table 5.12. EBRD indices of structural reform and institution building in Russia

Reform sphere	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Liberalization										
Price liberalization	3	3	3	3	3	3	2,7	2,7	3	3
Liberalization of trade and exchange operations	3	3	3	3	4	4	2,3	2,3	2,3	2,7
Privatization										
Privatization of small enterprises	2	3	3	4	4	4	4	4	4	4
Large-scale privatization	2	3	3	3	3	3,3	3,3	3,3	3,3	3,3
Enterprises										
Enterprise restructuring	1	1	1,7	2	2	2	2	1,7	2	2,3
Business environment	2	2	2	2	2	2,3	2,3	2,3	2,3	2,3
Infrastructure										
Reforms in infrastructure	-	1,3	1,7	1,7	2	2	2	2	2	2
Financial organizations										
Banking system reform	1	1	2	2	2	2,3	2	1,7	1,7	1,7
Reform of non -banking financial institutions	1	1,7	1,7	2	3	3	1,7	1,7	1,7	1,7
Judiciary base *(corporate law)*										
Legislative sphere	-	-	-	-	-	3,3	3,7	3,7	3,7	3
Law enforcement efficiency	-	-	-	-	-	3	2	2,3	3	3,7

Note: Structural and institutional changes are scored on a one-to-four scale.
Source: EBRD (2001; 2002)

Over 140,000 enterprises have been privatized in Russia since 1992. The EBRD rates the results of Russian privatization positively: 3.3 for large-scale privatization and 4.0 for small privatization. However, the ratings for corporate governance and structural reform (2.3), enterprise restructuring (2.3) and business environment (2.3), provide a more mixed picture (see Table 5.12, which also contains other indices of structural and institutional reform).

Unlike in the leading transition countries, in Russia the establishment of new ('green field') private firms has not become a major source of private sector growth. This can be explained by bureaucratic and administrative barriers, widespread corruption, lack of transparency, instability and contradictions in economic legislation, i.e. high transaction costs, which reflect the poor business and investment climate. While small private businesses exhibited relatively rapid growth in the early years of Russia's transition (their share in value added more than doubled, from 10% to 23%, between 1991 and 1998), their number and shares of total employment and output have virtually stagnated since the mid-1990s. This is in striking contrast both to the overall economic expansion of 2000-2002 and the situation in the CEB region, where SME development is regarded as the basis for future economic growth, and the shares of new private enterprises in employment and value added exceed 40% (World Bank, 2002, pp. 40-42).

The estimated expenses of Russian entrepreneurs overcoming administrative barriers and bureaucratic control accounted to USD 8-8.5 billion (about 1% of GDP based on purchasing power parity) in 2000 (Kryuchkova, 2001, p. 19, quoted by Yasin, 2003, p. 212).

5.5. Composite development indicators

The composite indicators calculated by various independent organizations confirm the relatively poor institutional characteristics of the Russian state and economy and a lack a visible progress in this sphere. These are related not only to the economic system but also to the areas of human rights, civil liberties, democratization, the quality of the legal system, justice administration, corruption, etc.

5.5.1. Freedom House indices

Since 1972, the Freedom House has published an annual assessment of political freedom worldwide on the basis of political rights and civil liberties, using a one-to-seven scale. Those countries with rating averages of 1-2.5 are generally considered 'free', those with 3-5.5 – 'partly free', and 5.5-7 as 'not free'.

Russia rated by FH since 1991, while technically remaining in the 'partly free' category, has seen a steady decrease in its rating, closely approaching 'not free' status (see Table 5.13). This remains in sharp contrast to the dramatic progress in democratization and human rights in CEB countries, which have moved from 'not free' to 'free' status over the past decade. More importantly, the progress in democratization and human rights standards has been closely correlated with progress in economic reforms. While causality here has been in both directions, the key element lies in political reforms acting as a factor determining economic progress and the business climate (see Chapter 3 and Dabrowski and Gortat, 2002).

Similarly to worldwide indicators, FH since 1997 in its 'Nations in Transit' study, has provided subcategory ratings and averaged scores that are signposts of progress or regress in

Table 5.13. Russia's 'Freedom in the World' Ratings, 1991-2002

Years	Score	Category
1991-92	3,3	PF
1992-93	3,4	PF
1993-94	3,4	PF
1994-95	3,4	PF
1995-96	3,4	PF
1996-97	3,4	PF
1997-98	3,4	PF
1998-99	4,4	PF
1999-00	4,5	PF
2000-01	5,5	PF
2001-02	5,5	PF

Source: FH (2003a).

political and economic reforms in 27 CEE and FSU countries. These scores are based on the following categories and subcategories: democratization (electoral process, civil society, independent media and governance), rule of law (constitutional, legislative and judicial framework), and (until 2002) economic liberalization (privatization, macroeconomic and microeconomic policy).

Table 5.14 indicates an ever-widening gap between Russia and CEE both in democratization and the rule-of-law categories (although Russia noted some improvement in the latter part in 2002). In the six transition categories which FH tracks Russia has experienced regress in all but one (corruption) since 1997.

Table 5.14. 'Nations in Transit' Scores, 1997-2003

Country/ Indicator	1997	1998	1999-2000	2001	2002	2003
Russia						
Democratization	3.80	4.10	4.25	4.63	4.81	4.88
Rule of Law	na	na	5.25	5.38	5.38	5.13
Economic Liberalization, incl.:	3.50	3.92	4.33	4.17	3.92	na
Privatization	3.00	3.25	3.75	3.75	3.50	na
Macroeconomic Policy	na	4.25	4.75	4.25	3.75	na
Microeconomic Policy	na	4.25	4.50	4.50	4.50	na
CEE averages						
Democratization	2.86	3.12	2.98	2.82	2.73	2.68
Rule of Law	na	na	3.69	3.59	3.51	3.43
Economic Liberalization	3.14	3.37	3.30	3.25	na	na

Sources: FH (2002; 2003)

5.5.2. Transparency International Corruption Perceptions Index

The TI Corruption Perceptions Index (CPI) ranks 102 countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. The CPI score is rated on a scale from 1 to 10 – a perfect 10.00 would be a totally corruption-free country.

While most CEE countries are perceived to be increasingly less corrupt, Russia, as well

Table 5.15. The Corruption Perceptions Index, 1998-2002

Country	1998		1999		2000		2001		2002	
	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank
Russia	2.4	76	2.4	82	2.1	82	2.3	79	2.7	71
Estonia	5.7	26	5.7	27	5.7	27	5.6	28	5.6	29
Hungary	5.0	33	5.2	31	5.2	32	5.3	31	4.9	33
Poland	4.6	39	4.2	44	4.1	43	4.1	44	4.0	45
Slovenia	na	Na	6.0	25	5.5	28	5.2	34	5.7	28
Ukraine	2.8	69	2.6	75	1.5	87	2.1	83	2.4	85

Source: http://www.transparency.org

as many FSU countries, remains ridden with corruption (see Table 5.15). The recent steps undertaken in Russia to introduce tax reforms and new legislation combating money-laundering may bring improvement in future rankings.

5.5.3. The Heritage Foundation Index of Economic Freedom

Since 1995, the HF Index of Economic Freedom rates each country by studying 50 independent economic variables. Economic freedom is defined as the absence of government coercion or constraint on the production, distribution and consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself.

The analyzed variables fall into 10 broad categories: trade policy, fiscal burden of government, government intervention in the economy, monetary policy, capital flows and foreign investment, banking and finance, wages and prices, property rights, regulation and black market activity. Each factor is scored according to a grading scale from 1 to 5: a score of 1 signifies a set of policies that are most conducive to economic freedom, while a score of 5 signifies a set of policies that are least conducive (Beach and O'Driscoll, 2003).

Table 5.16. The HF Index of Economic Freedom, 1995-2003

Year		Russia	Estonia	Hungary	Poland	Slovenia	Ukraine
1995	Score	3.40	2.40	3.00	3.30	na	3.70
	Rank	69	18	41	59	na	85
1996	Score	3.50	2.50	3.00	3.10	3.50	3.80
	Rank	93	28	61	71	93	118
1997	Score	3.55	2.50	3.00	3.10	3.30	3.75
	Rank	106	32	68	73	89	122
1998	Score	3.35	2.30	3.00	2.90	3.00	3.80
	Rank	95	24	71	61	71	123
1999	Score	3.50	2.35	2.95	2.80	2.90	3.60
	Rank	110	30	69	52	62	126
2000	Score	3.70	2.20	2.55	2.80	3.00	3.60
	Rank	122	22	41	53	74	116
2001	Score	3.70	2.05	2.55	2.75	2.90	3.85
	Rank	127	14	42	54	63	133
2002	Score	3.70	1.80	2.40	2.70	3.10	3.85
	Rank	131	4	32	45	79	137
2003	Score	3.70	1.80	2.65	2.90	2.85	3.65
	Rank	135	6	44	66	62	131

Source: O'Driscoll, Feulner, and O'Grady (2003).

As Table 5.16 indicates, Russia is the only country (among the chosen set of transition economies) to have demonstrated a consistent deterioration in its degree of economic freedom in the course of the past eight years and remains among the least free countries in the region. Despite several achievements in the economic sphere (e.g. tax reform), the trend toward increased political and administrative regulation is characterized by a growing bureaucracy, cutbacks in regional autonomy, interference in regional elections, crackdowns on the independence of the media, the granting of increased power to the country's security agencies and a reluctance to introduce military and judicial reforms (O'Driscoll, Feulner, and O'Grady, 2003). Across the board, Russia scores poorly in almost all of the factors, with the one exception of government intervention (2.5). Moreover, similar to the FH indices, HF figures indicate a widening gap between Russia and the CEB countries.

5.5.4. The Fraser Institute's Economic Freedom of the World (EFW) Index

Somewhat similar to the HF index, the EFW index measures the degree of economic freedom across 123 countries in five major areas: size of government (expenditures, taxes, and enterprises); legal structure and security of property rights; access to sound money; freedom to exchange with foreigners; and regulation of credit, labor, and business. Counting the various sub-components, the EFW index utilizes 38 distinct pieces of data. Each component and sub-component is placed on a scale from 0 to 10 reflecting the distribution of the underlying data. The component ratings within each area are averaged to derive ratings for each of the five areas. In turn, the summary rating is the average of the five area ratings (Gwartney and Lawson, 2003, p. 6).

Table 5.17. EFW Index , 1990-2001

Year		Russia	Estonia	Hungary	Poland	Slovenia	Ukraine
1990	Score	na	na	5.0	4.0	Na	na
	Rank	na	na	74	101	Na	na
1995	Score	4.0	5.6	6.3	5.3	4.9	3.5
	Rank	116	74	46	82	92	122
1997	Score	5.1	6.7	7.2	6.2	5.9	4.2
	Rank	91	54	47	61	73	108
1999	Score	3.9	7.4	7.1	5.7	6.2	4.6
	Rank	117	36	43	85	72	106
2000	Score	4.5	6.9	6.6	5.8	5.9	4.5
	Rank	118	41	52	81	77	118
2001	Score	5.0	7.5	7.0	6.0	6.1	4.6
	Rank	112	16	35	77	73	117

Source: http://www.freetheworld.com/2003/EFW2003Dataset.xls

Similarly to the HF index, the EFW index rates Russia very close to the bottom of the country list (Table 5.17). One important difference, however, are the positive, albeit slight, dynamics of the EFW index scores: Russia's rating rose from 116 to 112 (out of 123) between

1995 and 2001. Across the board, Russia (like most post-communist countries) rates relatively better in freedom of foreign trade (74, on a par with Poland) and size of government (73, higher than most CEB economies), but lags far behind in access to sound money (112) and especially in regulation of credit and business (119).

6. Main Hypotheses and Results of Their Testing

When we started our work we formulated six preliminary hypotheses partly following proposal formulated by Schmidt-Hebbel (2003). These hypotheses were tested using mostly a narrative, qualitative analysis method. Below we summarize our main findings, confirming or rejecting these hypotheses. The findings are based on analyses conducted in the previous chapters of this study.

6.1. Hypothesis 1: Domestic crises beget reforms

According to the findings of much research into the political economy of policy reform (see e.g. Williamson, 1994; Drazen and Easterly, 2001; quoted by Fidrmuc and Noury, 2002, Blaszkiewicz and Paczynski, 2003) 'crises induce reform'. The mechanism here seems to be rather straight forward: the previous political and economic system (or one of them) becomes increasingly ineffective and needs correction. However, defenders of the *status quo* are much stronger than advocates of change, which means reforms blocked. In the meantime inefficiencies/ distortions/ imbalances/ conflicts caused either by flawed institutions or bad policies, or both, gradually cumulate, leading to a crisis. A crisis itself can also be provoked by an external economic or political shock. As a result of the crisis the dominant anti-reform coalition may collapse or become seriously weakened and advocates of changes gain strength.

The history of the Russian transition (see Chapter 2) clearly demonstrates that reforms were generated by the development of the preceding crisis. Starting from the very beginning of the analyzed period, Gorbachev's *Perestroika* was pushed by the deep systemic crisis of the centrally planned economy and its inability to generate further economic growth (see Ofer, 1987; Gaidar, 1997; Aslund, 2002). Russia's average rate of economic growth consistently declined throughout the 1970s and 1980s and the Soviet leadership faced increasing problems in meeting the challenges posed by the Arms Race and the ideological and geopolitical confrontation with the US and the rest of the free world.

The limited character and inefficiency of Gorbachev's reforms (particularly in the economic sphere) led eventually to the hidden hyperinflation of 1990-1991, and in turn to the collapse of the communist economic and political regime, the dissolution of the Soviet Union in 1991 and gave birth in effect to the 'revolutionary' period of Russia's reforms.

As the 'revolutionary' reforms initiated at the end of 1991 by President Boris Yeltsin and Yegor Gaidar were insufficiently fast, consistent or fully thought out due to the limited political window of opportunity and lack of sufficient strength of the pro-reform coalition (see below), macroeconomic performance remained poor (see Chapter 5). Chronic macroeconomic instability led to a series of currency crises, including 'Black Tuesday' of October 11, 1994, which opened the door to the more thorough stabilization policy of 1995 at least in the monetary policy sphere.

The period 1996-1997, while continuing the fragile and illusory price and monetary stability achieved in 1995, contributed to a building up of huge fiscal imbalances. The subsequent attempts at fiscal adjustment and structural and institutional reform failed because of opposition from the communist-dominated Duma and the influence of powerful 'oligarchs' lobbies. Again it had to lead to crisis.

The August 1998 financial crisis seriously reshaped both the political map of Russia and the configuration of special interest groups. With a certain time-lag it helped to elect an economic reform-friendly parliament (December 1999) and President (March 2000), contributing to a consolidation of political power. In turn, a comprehensive reform package (the so-called Greff program) could be implemented in a more consistent and thorough way than previous reform attempts.

Summing up, each of the above mentioned crises reflected the lack of possibility of carrying on the previous ineffective policies. By generating economic and political shock across the whole of society and political elite, each subsequent crises helped to weaken the dominant groups of special interests and soften their resistance to necessary adjustment. Thus, Russia's experience appears to support the observation that 'crises induce reform' and helps explain, in political economy terms, the mechanisms that transmit crisis shock into new rounds of reform.

6.2. Hypothesis 2: External factors shape reform

In many countries the role of various external factors, such as economic shocks coming from international/ regional markets, learning/imitation from other countries, the influence of the IMF, World Bank, WTO and other international organizations, and finally EU accession prospects, have all played a powerful role in shaping the pace of economic (and political) reform. However, in the case of Russia their influence seems to have been less explicit than, for example, the role of domestic political and economic crises described in the previous subsection. In order to verify more precisely this important hypothesis we will try to analyze separately five main components of the 'external factors' vector, i.e. (i) changes in oil prices, (ii) the situation on the international financial markets, (iii) foreign aid, (iv) the role of international organizations and (v) learning from other countries' experiences.

6.2.1. Oil prices

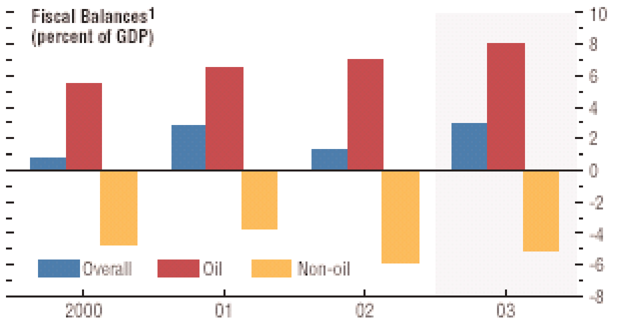
A particular role in Russia's reform history has been played by fluctuations in international oil prices – the major export commodity of the country. However, this role has not been as explicit as one might expect, particularly bearing in mind the experience of other oil-exporting countries.

Two oil shocks in the 1970s increased oil prices more than ten-fold (see Table 2.1 in Chapter 2). This allowed the USRR to continue its heavily distorted industrialization strategy and forget about the necessity of reforming its economic and political systems for at least another decade (see Gaidar, 1997, Chapter 5). The decline in oil prices in the second half of the 1980s worked in the opposite direction, however, creating an additional incentive (apart from domestic and geopolitical considerations) to find a new economic mechanism aimed at increasing the effectiveness of the Soviet economy. However, another increase in oil prices at the beginning of the 1990s and then a stabilization at a relatively high level did not have any visible impact on the 'revolutionary' phase of reforms (neither helping, nor halting reforms).

The decline in oil prices in 1997 and 1998 (a relatively short-living consequence of the Asian financial crisis) contributed, to a certain extent, to the crisis developments in 1998 but cannot be considered as the major factor responsible for the eruption of the crisis (again this was mainly driven by domestic policy weaknesses).

Finally, the increase in oil prices starting in the second half of 1999 helped to restore economic growth, the balance of payments and fiscal equilibrium and lower the social costs of the reform package implemented at the beginning of the 2000s. On the other hand, it also lowered incentives to reform ineffective public services such as national defense, police and other law-enforcement agencies. It also made it possible to finance the Second Chechen War without visible negative consequences for fiscal balances. Deterioration of non-oil fiscal balances in the beginning of the 2000s (reflecting a trade-off between real fiscal adjustment and consuming 'windfall' oil revenues) is well illustrated in Figure 6.1.

Figure 6.1. Oil and Non-oil Fiscal Balances



Note: [1] Federal budget operations (commitments).
Source: IMF World Economic Outlook 2003, p. 42.

6.2.2. International financial markets

In this area it makes most sense to analyze only a relatively short period of time, 1996-1998, i.e. starting with the opening of the domestic T-bills market to foreign investors in 1996 and ending with the August 1998 financial crisis (which closed Russia's access to international markets for many years). In 1996 and the first half of 1997 huge investor optimism in relation to emerging markets helped bring in relatively large and cheap capital inflows into Russia, thus in turn softening borrowing constraints faced by the federal government. Without this source one might have expected two hypothetical scenarios: either a financial crisis would have happened earlier (end of 1996 or early 1997) or government/ parliament would have been forced to conduct fiscal adjustment.

The situation changed after the Asian crisis, which hit investor sentiment in emerging markets, particularly in countries with weak fundamentals. This factor additionally complicated the macroeconomic situation in Russia at the end of 1997 and first half of 1998 and probably accelerated the beginning of the August 1998 crisis. However, it did not play a fundamental role itself in provoking the crisis (which should be attributed more to domestic fiscal imbalances and delaying structural and institutional reforms) and determining the course of the reform process in Russia.

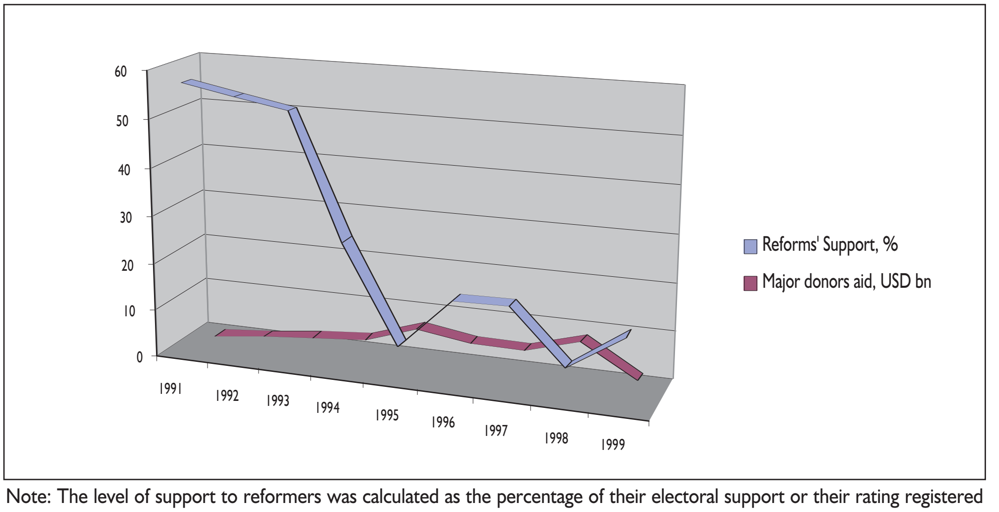
6.2.3. Foreign aid

The importance of foreign aid in leveraging the Russian reforms has generally been limited and its influence on domestic policy agenda somewhat controversial. In spite of the strong political engagement of the US and other G-7 governments and relatively substantial financial and technical assistance provided by bilateral and multilateral donors (see Chapter 4), one would be hard pressed to claim that these interventions helped build a pro-reform coalition in Russia or lower the social costs of economic reforms.

The crucial problem was connected with the timing of this assistance. The initial political window of opportunity for carrying out radical reforms was relatively weak and limited in time compared, for example, to the CEB countries (see Chapter 2). It started after the failure of Yanaev's coup d'etat in August 1991 but had already at least partly closed after the April 1992 Congress of People Deputies (see Gaidar, 1999; Mau, 1996).

However, more substantial Western aid started to come in the second half of 1992 only when the limited political window of opportunity was already partly closed. The same happened with a short window of opportunity created by the defeat of a key anti-Yeltsin rebel in October 1993. Far from it, in fact, with the IMF and World Bank (under G7 political guidance) evidently overestimating the political window of opportunity connected with the government of 'young reformers' in 1997 (see Zanini, et al., 2002; Zhavoronkov, 2001). The lack of coordination between domestic political conditions and aid flow is well illustrated by Figure 6.2.

Figure 6.2. Support to reformers and financial aid of major donors, 1991-1999



Note: The level of support to reformers was calculated as the percentage of their electoral support or their rating registered by public opinion polls, as follows: June 1991 Presidential election voting for Yeltsin, April 1993 referendum – answer 'Yes" to the second question on support for economic reforms; December 1993 Duma elections – the sum of votes for democratic parties (Democratic Choice of Russia, RMDR, Yabloko) lists; 1995 Duma elections – the sum of votes for party lists of DCR, 'Russia, Forward!' and a number of small reformist groups; 1996 presidential elections (right-wing liberals plus the conditional 10% of Our Home Russia); 1997 – B. Nemtsov's rating until the last quarter (almost 18%); 1999 Duma election – support for SPS (Union of Right Forces) and Yabloko.
Source: GAO (2000) and IET research on election support for reformers.

The question of the timing of aid to Russia has been the subject of controversy in the relevant economic literature. For example, Jeffrey Sachs (1994a; 1994b) claims that providing massive assistance to Russia as early as the end of 1991 and beginning of 1992 would have helped extend the window of opportunity and maintain the reform momentum, on one hand, and increase Western influence on the course of the Russian reforms, on the other. Failing to do it meant losing a unique historical chance for a fast and effective transition in Russia.

Although very appealing, the idea of bringing massive assistance to Russia at this early stage at the end of 1991 does not look ex post very realistic for several reasons.

Firstly, Russia was not yet an IMF or World Bank member at that time (it joined both organizations in June 1993). As such, any large-scale Western financial aid would have to be provided on a bilateral or multilateral basis by the G7 outside IMF and WB channels (see also Rostowski, 2001 on this topic).

Secondly, G7 governments were not conceptually, technically or organizationally prepared to provide such large-scale assistance to Russia at that time. The same concerns the IMF and World Bank. In addition, knowledge about real Russian assistance needs was very limited on both sides (i.e. the Russian and donor side).

Thirdly, the Russian authorities did not have the adequate administrative and technical capacities to absorb larger scale financial (and technical) assistance at that time.

Finally, one should answer the most important question: could such large scale assistance at the very beginning of Russia's transition (end of 1991, beginning of 1992) really have changed the course of economic (and political) events in this country in favor of faster and more thorough reforms? There are many doubts on this score. The politics and political economy of the Russian transition was so complicated from the very beginning (and anti-Western sentiments were strong) that Western financial assistance would hardly widen the political window of opportunity. Wasting this assistance for current consumption and delaying reforms (which was, by the way, a typical effect of substantial trade credits obtained by Russia during the last years of Perestroika and at the beginning of the 1990s) seemed to be a more likely scenario.

6.2.4. The role of international organizations

The IMF and World Bank had some influence on the short-term reform agenda and its technical characteristics but failed to create sufficient long-term incentives for the reform process through their policy conditionality (see Chapter 4 for details). Their interventions did not help build a pro-reform coalition inside the country nor the country's ownership of economic reforms. Even worse, between 1995 and 1998, the soft and inconsistent conditionality of IMF programs contributed to the building up of an illusion of macroeconomic stability, which in fact was very fragile and unsustainable, i.e. misleading, in some way, Russian policymakers and financial market players (see Gianini et al, 2002; Antczak, Markiewicz and Radziwill, 2003).

Starting from 2000 the prospect of joining the World Trade Organization has had a certain influence on economic legislation and economic policy, particularly in the area of trade regime, taxation, corporate and banking law, standardization, protection of intellectual property rights, etc. However, the speed of this adjustment has not been very high and the WTO accession process may take another couple of years.

In future, a similar influence may possibly be attributed to Russia's cooperation with the EU – particularly the long-term goal of creating a Common European Economic Space between Russia and the enlarged EU, which may impact several areas of institutional reform in the economic and political spheres.

6.2.5. The experience of other countries

Learning from other countries' experience also had some, but very limited, influence on the course of domestic professional and economic debate. While CEB countries (mainly Poland) served as positive examples of successful reforms, the experience of Ukraine, Belarus and Bulgaria (in the mid 1990s) was sometimes used as a warning signal demonstrating the negative consequences of populist ideas and policies. The Latin American experience (both positive and negative) was also discussed in professional circles.

6.3. Hypothesis 3: Reform success depends on the organization of winners

This seems to be a very obvious if not rather trivial hypothesis. At the same time, however, following this kind of recommendation in a practical sense in the post-communist transition was almost impossible for one simple reason: the future winners of the on-going reforms were hard to organize because either they lacked power or did not exist at all at the very beginning of transition (like private entrepreneurs or the middle class). In contrast, potential reform losers were fewer and wield more power and therefore have been more likely to organize interest groups opposing reforms (see Olson, 1994; Schmidt-Hebbel, 2003). In addition, some early (intermediate) winners may not necessarily have had the chance to become ultimate winners so will have the temptation to seek to take control over the reform process in order to put a stop to it, slow it down or distort in favor of their interests (see below).

In the case of former communist countries initial support for market reforms was not explicit in the sense that while people realized the inefficiencies and distortions of the command economy they did not really understand what specifically must be done in order to make the economic system effective and internationally competitive, and what would be the social costs of such reforms (including the costs of their own adaptation). The dominant feeling was against communism and the command economy rather than for any concrete economic reform blueprint. Generally, a lot of wishful thinking and economic illusions accompanied the collapse of communism.

Thus, support for radical economic reform had an indirect character: it was connected with the anti-communist, pro-freedom, pro-democratic and pro-independent movement. If people, and particularly the political elite, understood that an open and efficient market economy was an absolutely necessary condition for building democracy, freedom and an independent national state they could provide relatively strong (though not indefinite – see Section 6.5) support for the economic reforms. This was the case of the CEB countries. As we mentioned in Chapters 2 and 3, initial support for democracy and freedom in Russia was much weaker and the 'independence' factor played no role (on the contrary, political and market reforms were associated with the collapse of Soviet empire – see Chapter 2). So the organization of political support for reforms became even more important and difficult than in countries with a larger political window of opportunity.

The organization of reform supporters/ winners can be considered at least on two levels: macro and micro. The first relates to the organization of a national political scene. In some transition countries a mass anti-totalitarian and pro-independent movement ('Solidarity' in Poland, 'Sajudis' in Lithuania, the civic movement in Czechoslovakia) also provided support for the initial economic reform package. In Russia the situation was again more complicated. The existing anti-totalitarian and pro-democratic organizations of the Perestroika period, like 'Democratic Russia', were not strong enough and lacked a clear economic program. On the other hand, the political camp which supported Boris Yeltsin in June 1991 Presidential election and resisted the August 1991 attempt at a coup d'etat was very heterogeneous in terms of its political and economic ideas and interests. So the economic reformers who came into government in November 1991 had to organize their own political base from scratch[25].

They managed to meet this challenge and built a relatively stable pro-market political formation (Democratic Choice of Russia/ Union of Right Forces). However, this grouping never enjoyed strong electoral support and its ability to build a wider and stable pro-reform coalition was limited. The latter changed after 1999 when so-called 'centrist' (pro-Kremlin) formations became more market oriented and when the goal of building a strong Russian state started to be identified with a well functioning market economy. In the meantime (and particularly in the early years of the transition) the advocates of radical market reforms were

[13] The importance of building their own political base by economic reformers was underlined several times by the current President of the Czech Republic Vaclav Klaus (see e.g. Klaus, 1997). See also Gaidar (1999).

forced to make compromises with their political opponents. As we demonstrated in Chapters 2 and 3, many of these compromises were counter-productive for reformers because they only strengthened the anti-reform coalition instead of building a pro-reform one26.

In addition, the failure to reform the courts and law enforcement agencies at the very beginning of the reform process not only contributed to a significant deterioration in the business and investment climate (see Chapters 3 and 5) but also created fertile ground for their 'capture' by the oligarchs, strengthening in this way the anti-reform coalition. The same concerns the distorted privatization of the electronic mass-media and control over media that formally remained in state hands (Zhavoronkov and Yanovskij, 2001).

When we look at a micro level, ex ante identification of potential winners has proved to be very difficult[27]. Ex post sociological analyzes clearly show that reform winners have been those who have shown a strong ability to adapt themselves to new market conditions (see Chapter 3). Unfortunately, the concrete policies conducted in the 1990s, often determined by political compromises (see above), damaged the interests of many of such defined winners. Failure to deconcentrate and demonopolize many important sectors, over-regulation, administrative harassment and corruption and privileges to the oligarchs, have all hampered the development of new small and medium sized private enterprises (see Chapter 5) and the building of a middle class. Failure to reform public services such as education, health care and public administration has contributed to a pauperization of the another potential part of a middle class, i.e. 'white collars' workers, civil servants and the intelligentsia, pushing many of them into the anti-reform camp. In addition, as we demonstrated in Chapter 3, federal fiscal transfers have helped opponents of reforms rather than reform winners and supporters (at least up to the end of the 1990s).

Summing up, the history of the Russian reforms confirms the importance of the organization of reform winners, but at the same time shows how difficult this task is in the case of a fundamental post-communist transition.

6.4. Hypothesis 4: Sequencing matters – virtuous vs. vicious cycle

The proper reform sequencing of the first stage of reforms has a strong impact on their subsequent course. Early liberalization and macroeconomic stabilization: (i) eliminates many

[26] Zhavoronkov and Yanovskiy (2001) quote the political statement of Yegor Gaidar when he analyzed the causes of the reformers' failure in 1997-1998: 'Each single compromise seemed to be reasonable and justified but all together went too far'.

[27] See Mau (1996) on the attempt to identify pro- and anti-inflationary forces in the early 1990s.

potential sources of rent; (ii) gives more open and equal opportunities to participate in business activity; (iii) minimizes income and wealth distortions; and (iv) provides opportunities for higher economic growth. The early success of the economic transition helps strengthen the constituency in favor of further reforms, both political and economic, triggering a kind of 'virtuous' circle or positive 'multiple equilibria'. This kind of scenario has been generally observed in the CEB region.

In contrast, too many compromises or improper sequencing of reforms (delayed stabilization and liberalization) in the early stage of transition can contribute to building a hybrid economic regime and powerful group of interests defending the intermediate status quo (see Krueger, 1993; Hellman, 1998). This is what happened in Russia, where various kinds of rent opportunities, from high inflation, multiple exchange rates, direct and indirect subsidies, tax exemptions, selective trade barriers, widespread licensing, weak banking supervision and non-transparent privatization process contributed to the building of oligarchic fortunes. The oligarchs captured most of the basic public institutions – executive, legislative and judicial power, regional and local self-government, political parties, and mass media, using them to enhance their own benefits and halting reforms whenever they have considered them to be challenging to their interests. The excessive income and wealth differentiations, deprivation of equal access to business activity for most of the society, widespread poverty, frustration and political apathy are the other side of the same coin. This has led to lower public demand for market reforms, creating a kind of 'vicious cycle' (or negative 'multiple equilibria').

The above described 'vicious cycle' (or 'reform trap'), which dominated in Russia through most of the 1990s, started to be reversed after the 1998 financial crisis. However, it took some time before the reform process gathered political momentum in fact, it happened only after the Presidential election of March 2000. The demand for reforms and market institutions started to increase when a significant part of the political and business elite had adapted itself to the new capitalist environment and become more interested in stable and transparent rules of the game. This process was further strengthened by the emergence of a larger group of small, medium-sized and large private entrepreneurs as well as other medium-class representatives who demanded equal access to business opportunities and the elimination of at least part of the administrative rents (which they had to pay). The results of the 1999 Duma elections well reflected the changing preferences of Russian society.

On the other hand, the financial crisis of 1998 forced the authorities to increase the level of fiscal and payment discipline, thus diminishing significant sources of rent extraction. In addition, the favorable external environment (high oil prices) allowed the social costs of the reforms to be lowered somewhat. This provided a chance to build a pro-reform coalition and initiate a 'virtuous' cycle (positive 'multiple equilibria') in turn underpinning further necessary changes.

The Russian reform experience positively verifies the hypothesis on reform equilibria ('virtuous' vs. vicious cycle).

6.5. Hypothesis 5: Fast reforms are more effective than slow ones

The question of the optimal reform speed has been subject of many key debates, particularly in the context of the post-communist transition[28]. In a more journalist fashion this controversy has frequently been called the 'shock-therapy vs. gradualism' debate, although the notion of 'shock therapy' seems to contain a rather emotional and pejorative association.

The arguments in favor of fast, comprehensive and thorough reform rather than slow and gradual reform refer mainly to three groups of issues:

- Expectation/ credibility when policymakers want to radically change the behavior of economic agents. This is quite obvious in relation to macroeconomic stabilization (combating high inflation or hyperinflation gradually does not make a lot of sense) but this argument keeps its rationale when one thinks about radical changes in microeconomic behavior (and this is exactly the case of the post-communist transition).
- Old institutions can damage new policies. This is again a very important argument in the case of the post-communist transition. In addition, there is a danger of a systemic vacuum when old institutions and economic mechanisms have already spontaneously collapsed (as a result of the democratization process) and new ones have not yet emerged.
- Political economy of the reform process

Table 6.1 summarizes these arguments in relation to the main components of the post-communist economic transition.

Table 6.1. What can be done gradually?

Area	Can be done gradually?	If YES, what are the main dangers or negative implications?
Macroeconomic stabilization	NO	
Domestic liberalization	NO; YES - In exceptional situations	Price distortions, inflationary expectations, fiscal problems, delayed dem onopolization and privatization
External liberalization	YES	Price distortions, weaker competition, less pressure for restructuring
Privatization	YES	Delayed restructuring, negative pressure for macropolicy, intensive rent -seeking, informal privatization
Restructuring of the state sector (subsidization)	YES	Delayed restructuring, fiscal crisis, other pressure for macropolicy, intensive rent -seeking, the information and political barrier in monitoring, credibility problem

Source: Dabrowski (1996).

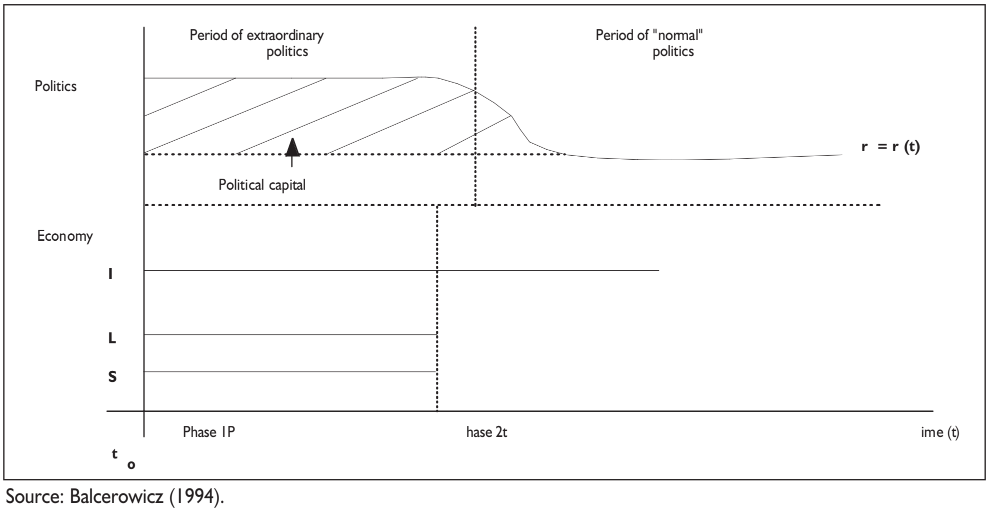
[28] See, among others, Fischer and Gelb (1991); Nuti and Portes (1993); Aslund (1994); Balcerowicz (1994); Balcerowicz and Gelb (1995); de Melo, Denizer and Gelb (1996); Dabrowski (1996); Aslund, Boone, and Johnson (1996); Stiglitz (1999a, 1999 b); Dabrowski, Gomulka and Rostowski (2001) and Mau (2000).

In further analyses we concentrate on political economy arguments. They are connected with the observation that the political window of opportunity for carrying out radical reforms is usually limited in time and should be used to maximum effect. Balcerowicz (1994) developed the concept of a 'period of extraordinary politics', meaning the special political window of opportunity just after the collapse of communism when people were ready to accept or at least tolerate more unpopular and painful reform measures than in 'normal' circumstances. In addition, various lobbies existing under the old regime become defeated or disorganized and it takes some time before new influential interest groups emerge. This kind of effect is also observed in stable democracies and is sometimes referred to as the 'honeymoon effect' (see Williamson, 1994).

Figure 6.3 illustrates the basic logic of this concept. Its lower part illustrates a radical economic strategy, as symbolized by the length of lines S, L and I. Alternative strategies would have longer lines, or would be shifted to the right, e.g. S shifted to the right would symbolize a delay in stabilization. The upper part of the diagram illustrates the political scene, and the function r=r (t) expresses the level of readiness to have radical economic measures accepted, starting at the moment to, which is close to a political breakthrough (i.e. collapse of communism). However, a high level of r can only be maintained for a relatively short time. The period of 'extraordinary' politics gives way to 'normal' politics, as described by public choice theory (e.g. Buchanan, 1993), when r is much lower.

Figure 6.3 also shows two phases of radical economic transformation. Phase 1 is dominated by the effects of those measures which work faster, i.e. S and L, and of faster institutional changes. If all these measures are undertaken shortly after a great political breakthrough, then phase 1 largely coincides with the period of extraordinary politics. Phase 2 consists of slower institutional reforms and has to be carried out during the period of 'nor-

Figure 6.3. Political and economic dynamics of the transition process



Source: Balcerowicz (1994).

mal' politics. However, if phase I is successful it can create a 'virtuous' cycle of the next phase (see previous section). So, the initial speed and consistency of reform also has important implications for the kind of 'cycle' that will prevail in the further stages of this process. Fast reform creates less opportunity to capture its intermediate results by 'early' winners.

The experience of the Russian transition has verified positively this hypothesis. Firstly, the political developments of 1991-1992 demonstrated the limited duration of a period of 'extra-ordinary' politics. Secondly, indicators presented in Chapter 5 confirm the dangers of a slow transition listed in Table 6.1. Thirdly, a comparison of Russia's performance with that of CEB countries (Chapter 5) shows that fast, radical and comprehensive reforms in the economic and institutional spheres helped to achieve better economic and social results than gradual and compromise ones[29].

Part of the intellectual confusion and misinterpretation of Russia's transition experience (blaming the so-called 'shock therapy' for unsatisfactory reform outcomes) derives from the fact that the pace of economic changes in Russia was generally slow (comparing to CEB countries), in spite of the 'revolutionary' character of the initial program declared at the end of 1991 by the Gaidar team and its radical rhetoric.

6.6. Hypothesis 6: Democratization helps market reforms

The interrelations between democratization and market reforms has been another hot topic of theoretical and empirical debate. Generally, empirical research shows at least a partial positive association between democracy and economic reform efforts and outcomes (see Schmidt-Hebbel, 2003; FH, 2003a). In the case of post-communist countries this interdependence seems to be even much stronger (see e.g. World Bank, 2002; FH, 2001, FH, 2003b; Dabrowski, and Gortat, 2002). It works in both directions, i.e. democracy and the market economy are mutually reinforcing (EBRD,1999, Box 5.3, p.113). On the one hand, democracy increases the transparency of government actions, constraints possibilities for rent-seeking and capturing state institutions and provides opportunities for long-term guarantees and stability of property rights (see also the findings presented in Chapter 3). On the other hand, the market system helps to develop civil society institutions, a broad middle class and a culture of cooperation based on self-interest, in turn also reinforcing democracy.

The ability of individual countries to start and follow fast and consistent reform strategies has been determined, to a large extent, by the scale of public support enjoyed by reformers,

[29] For deeper empirical evidence related to a wider group of countries see WEO (2000); EBRD (1999); EBRD (2000); World Bank (2002).

which, in turn can be explained by the radicalism of initial political changes (see Chapter 3 on the importance of the results of the first free election; Aslund, 2002; Dabrowski and Gortat, 2002). If the old communist elite is replaced by the new one convinced of the need to build a democratic order and market economy (and able to do it) it can give a country a longer period of 'extraordinary politics' and a chance to exploit this window of opportunity in the proper way.

In the case of Russia, only partial elite change did took place after the collapse of communism and the disintegration of the USSR. So the process of economic transition was, to a significant extent, controlled and distorted by the post-communist 'nomenklatura' and newly emerging 'oligarchs', who were not interested in open society institutions and transparent market mechanism (they did not represent demand for reforms and new market institutions) and they tried (successfully to a significant extent) to capture state institutions and use them for their own benefit. This is well reflected by the social and institutional indicators presented in Chapter 5. Cross-country comparisons of political, institutional and economic variables (Chapters 3 and 5; Dabrowski and Gortat, 2002) also enable an explanation of Russia's disappointing transition results in terms of a democratic deficit, human rights deficit and civil liberties deficit. Similar conclusion can be drawn from the interregional analysis presented in Chapter 3. If the recently observed authoritarian drift in Russia (e.g. limiting the role of the independent mass media) continues it may also in turn seriously damage the prospects of economic reforms.

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