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EXPLODING THE MYTHS ABOUT ECONOMIC REFORM IN RUSSIA

INTRODUCTION

The highly publicized hardships of Russia's transition to a market economy have led many to conclude that free market reforms have failed in Russia. Increasingly, Russian opponents of reform are charging that President Boris Yeltsin's policy of "shock therapy" —the term for a rapid transition to a market economy—has destroyed the economy and created nothing but misery for millions of Russians.

It was inevitable that Russia would encounter severe problems as it moved toward a market economy. What is being attempted, after all, is nothing less than a complete restructuring of the nation's economic and political systems. Over seven decades of communist rule, moreover, have left Russia's reformers with no market institutions on which to build. And a sizeable number of former Communist Party *apparatchiki* well-situated in positions of influence and power in the government and the bureaucracy are working, often successfully, to block and even reverse reform.

Myths that Impede Reform. Reform of any type in any country always disrupts the status quo, and thus angers those who benefit from prevailing conditions. Russia is no exception. The Yeltsin government's reforms face concerted opposition from the military-industrial complex, old Communist Party functionaries, and others who benefitted from privileged positions in the former Soviet Union. These opponents of reform, along with naysayers in the West, perpetuate several damaging myths that hobble the progress of reform. They are:

Myth #1: The policy of radical economic "shock therapy" has been tried in Russia. This is not true. Although the Russian government has adopted important, even radical, reforms such as price liberalization, the totality of its reform program amounts to little more than a package of half-measures, which at best have been half effective. "Shock therapy" has been tried in Poland and Czechoslovakia—and has succeeded in those countries—but has not been tried in Russia.

Myth #2: **Radical reforms have impoverished the Russian nation.** This is not true. The problem with the Russian economy today is not radical reforms, but their absence. Indeed, instead of being scaled back, credits and subsidies to state enterprises actually have increased, resulting in hyperinflation and the impoverishment of millions of ordinary citizens. And the government's failure to legalize private land ownership and construct a legal regime that protects private property rights has resulted in a paucity of new private-sector job opportunities for Russian workers.

Myth #3: **The decline of Russia's industrial sector and the rise of small shops and retail-trade outlets is bad for the Russian economy.** This is not true. Russia's industrial sector is outdated and antiquated, and thus produces a surplus of goods neither wanted nor needed by the Russian people. Its decline, therefore, will free scarce resources for new private sector development in Russia's highly underdeveloped service and retail trade sector. This will create the types of goods and services needed by Russian consumers, as well as the capital needed for the development of modern high-tech industry and Western-style free market prosperity.

Myth #4: **Russia's unique history and culture give it an inhospitable environment for the development of Western-style entrepreneurial capitalism.** This is not true. Russia's history and culture, to be sure, have created problems unique to Russia that make the establishment of a free market economy there difficult. But this has been true in all countries that have embraced entrepreneurial capitalism. Russia's problems may be more intractable than most, but they are not insurmountable. In fact, before the Bolshevik takeover in 1917, Russia had one of the world's fastest growing capitalist economies. And despite all the difficulties, entrepreneurial capitalism is doing surprisingly well in Russia today, accounting for at least 20 percent of gross national product.

EXPLODING ECONOMIC MYTHS

The many myths perpetuated by enemies of reform are damaging the prospects for a free and prosperous Russia. They affect the political climate not only inside Russia, but in the West as well. Western journalists adopt these myths and spread them in their coverage. It is very important, therefore, to debunk these myths, not only to advance reform inside Russia, but to develop in the West a proper understanding of Russia's problems.

Myth #1: The policy of radical economic "shock therapy" has been tried in Russia.

Russia's economic reform program is regularly depicted by the Western media as a hastily implemented and break-neck dash to a free-market economy.[1] Russia, so the argument goes, is attempting to make the transition to capitalism in one huge leap by means of "shock therapy," in which market conditions are imposed forcibly across the entire economy. The Russian government supposedly has a sink-or-swim attitude toward a bewildered citizenry and the ill-prepared state-owned industry alike. According to those who hold this view, the tremendous political and economic difficulties produced by "shock therapy" have only deepened economic failure in Russia. The pain, they say, is not worth the cost because no prospects for success are in sight. What Russia should instead attempt to do, it is argued, is to moderate the speed and scale of its move toward the market in favor of a more balanced process that is less costly to industry and the public.

Russian Reality. Russia's economic difficulties, however, are not caused by "shock therapy." Quite the contrary: they result from the government's failure to adopt a truly radical and comprehensive economic reform program. In many areas—control of the money supply, agricultural reform, and privatization, for example—there has been far less structural change than is even minimally necessary for the functioning of a market economy. Far from sweeping away the restrictions that impede Russia's private sector, the government instead has erected many new impediments over the past year. Even some of Russia's liberalizing programs have been cut back or modified because of their perceived negative effects on the economy. The result has been a package of half-measures, few of which have achieved their stated aims, and which collectively often have produced little but chaos. "Shock therapy" cannot be said to have failed because it has not yet been tried.[2]

In some areas, there has indeed been extensive change. Take, for example, price liberalization—the freeing of prices from government control. In January 1992, the Russian government launched its economic reform program by freeing prices on 90 percent of goods and services. But price liberalization is only one aspect, albeit an important one, of a comprehensive economic reform program. A free-market economy, after all, is comprised of much more than free prices. To function effectively, free prices must exist in the complex environment of a free market, which requires private property, private businesses, and the "soft infrastructure" of basic laws and institutions to facilitate

1 David M. Kotz, "No More Radical Reform," *The New York Times*, December 15, 1992, op-ed page; "Russia's Days of Shock Therapy Are Over," *The Wall Street Journal*, December 16, 1992, p. A10. The article begins with the sentence: "Shock therapy in Russia is dead," and is subtitled, "New [Russian] Premier is Wary of Unbridled Market Forces." This assumes, of course, that the government had, in fact, adopted a policy of "shock therapy" which allowed for the working of "unbridled market forces." This has not, however, been the case.

2 "Two steps forward, one step back, one step sideways," *The Economist*, July 4, 1992; Marshall I. Goldman, "Yeltsin's Reforms: Gorbachev II?" *Foreign Policy*, No. 88 Fall 1992; "Russia: The sixth wave," *The Economist*, December 5, 1992; "Eastern Europe: Heading for Reform, Facts, Problems, Prospects. Issue 1: Russia," Deutsche Bank Research, December, 1992; Eleanor Randolph, "Russia Reimposes Food Price Controls: New Premier Rolls Back a Gaidar Reform," *The Washington Post*, January 6, 1993, p. A19. World Bank, "Russian Economic Reform: Crossing the Threshold of Structural Change," *A World Bank County Study*, Washington, D.C., August/September 1992.

private-sector entrepreneurial activity. Among these laws and institutions are legal arrangements governing ownership, corporations, labor, pensions, bankruptcy, banking, monopolies, and taxation.

Yet legal reform and privatization so far have proceeded slowly. The Russian legal code, for example, still classifies a significant degree of entrepreneurial activity as criminal conduct punishable by law.[3] Since no clear right of land ownership yet exists, more than 90 percent of the farm land is still owned by the state, as are more than 90 percent of commercial and industrial properties. Significant tariffs and other barriers to foreign trade and investment remain in place. Private-property rights lack adequate legal protection. Less than 3 percent of the state housing stock has been sold off to residents.[4]

Domestic trade is still largely regulated and restricted by the state. Small-scale privatization has yet to get off the ground in most of Russia.[5] And measures adopted by the central government to promote economic reform often are ignored by local and regional governments.

Moreover, not all prices have been freed from government control. Indeed, the prices of some of the Russian Federation's most important commodities, most notably energy products such as oil, remain fixed at far below market levels. The price of oil in Russia, for example, is only 20 percent of its world market price. Yet, because oil is a vital part of a modern, industrialized economy, price controls on it and other energy products have led to gross price distortions throughout the Russian economy. Price controls on oil and energy have proved especially costly since energy exports are the single largest source of Russian hard currency earnings and government revenues. Yet because of price controls on energy products, incentives to produce are lacking, leading to a 30 percent decline in energy production since 1987.[6]

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3 John D. Sullivan, "Russian Reforms and Entrepreneurship," *Economic Reform Today*, Center for International Enterprise (CIPE), Washington, D.C., Fall 1992. According to Sullivan, laws that criminalize entrepreneurial activity are, "by and large," "not enforced today, even though they are on the books." Perhaps, but Russian reformers and entrepreneurs still complain of harassment by state officials and insist that not a small number of entrepreneurs are legally punished for legitimate entrepreneurial activity, often by regional and city governments that are less reform-minded than the Russian central government and that often solicit bribes which make the cost of entrepreneurship prohibitive. Laws against private-sector initiative could well take on a new life, moreover, in the event of a hard-line crackdown on the Russian "mafia," which officials typically construe to include honest and dishonest entrepreneurs alike.

4 Central Intelligence Agency (CIA), "Measuring Russia's Emerging Private Sector," *Intelligence Research Paper*, Washington, D.C., November 1992.

5 According to the International Finance Corporation, there are between 250,000 and 300,000 small shops, restaurants, retail-trade outlets and the like in Russia, less than 50,000 of which have thus far been privatized. Most of the small-scale enterprises that have been privatized, moreover, are located in only a few major cities such as Nizhny Novgorod, Moscow, and St. Petersburg.

6 John Lloyd, "Bank row stifling Russian oil output," *Financial Times*, October 11, 1992; World Bank, "Russian Economic Reform: Crossing the Threshold of Structural Change," *op. cit.*, Chapter 14, Reforming the Energy Sector, pp. 175-191.

There have been, of course, many successes in the Russian government's economic reform program. Perhaps the most prominent accomplishment is that Russia has cleared the formidable psychological hurdle of accepting the necessity for a transition to a market economy. Still, the fact remains: the government has not yet implemented a comprehensive and far-reaching economic reform program. The Russian economy has been "shocked" not by moving too quickly toward a free market, but by moving too slowly.

Myth #2: Radical reforms have impoverished the Russian nation.

What has impoverished Russia is not radical economic reform but a lack of radical reforms. The old command economy is disintegrating, yet a market economy is not rising fast enough to take its place. For example, anti-reformers often blame Yeltsin's price liberalization program for much of Russia's economic misery. In January 1992, the Russian government freed prices on 90 percent of goods and services. This caused a one-time price hike of 250 percent, which, it is alleged, impoverished millions of Russians.

In fact, however, price liberalization has had a positive effect on Russian living standards. It resulted in a rapid increase in the supply of goods and services, and largely eliminated most shortages. It also has sharply reduced the length and number of queues. Moreover, because there are fewer shortages from which black market entrepreneurs can profit, suppliers in Russia's informal sector increasingly have been pressured by the market to lower their prices. Price liberalization, therefore, has made Russia's growing entrepreneurial sector more accessible to consumers and more responsive to their needs.

What has impoverished millions of Russians is not radical reform but hyperinflation, which has resulted from the government's failure to adhere to a sufficiently radical and far-reaching reform program.[7] Russian hyperinflation—now running at a rate of more than 50 percent a month—in turn has been caused by the government's continued support of inefficient state enterprises through increased subsidies and easy credits.

The record is clear in this regard. During the first quarter of 1992, the government tried to rein in spending to curb inflation and give the ruble a stable value. After the initial, one-time price hike of 250 percent in January caused by price liberalization, inflation was brought gradually down to about 10 percent a month by late spring. But the government reversed course in April when it substantially increased subsidies and loans to state-owned industries to shield them from market pressures. As a result, the budget deficit rose from 1.5 percent of gross domestic product in the first quarter of 1992 to 11 percent of GDP the following quarter. Spending substantially increased again during the third and fourth quarters of 1992, thereby driving the quarterly budget deficit to 15 percent of GDP.[8] This was compounded by the explosion of easy credit to these

7 According to a survey done for the *Washington Post* by the independent Moscow-based Center for Marketing Research, "8 out of every 10 Russians have gotten poorer over the past two years. Their average purchasing power is just 42 percent of what it was in 1990." Moreover, "the average Russian family now spends 75 and 80 percent of its income on food, up from about 50 percent a couple of years ago." Since last October, when this survey was commissioned, these problems have gotten worse. Michael Dobbs, "Russian Reforms Impoverish Millions," *The Washington Post*, October 1, 1992, p. A20.

8 "Russia: The Sixth Wave," *The Economist*, *op. cit.*

by the Central Bank, a change of course brought about by the appointment of Viktor Gerashchenko as head of the Bank in July.

Russia's runaway inflation has proved costly for all social classes because it has sharply reduced the value of the ruble, which has declined in value against the U.S. dollar by 180 percent since only last September and 270 percent since last July. The collapse of the ruble has been a great impediment to commercial exchange and to private-sector entrepreneurial activity. Indeed, Russian entrepreneurs increasingly are divesting themselves of their rubles and embracing hard currencies, particularly the dollar. But the dollar and other hard currencies are in short supply in Russia, and the government has taken measures to restrict their use.[9]

Consequently, there has been a rise in barter exchange, which is far less efficient and productive than using money and far less conducive to economic growth and development.

If present trends continue, the inflation rate in Russia for 1993 will be more than 5,000 percent. Although inflation adversely affects all social classes, its burdens are most painfully borne by the poor and the elderly pensioners, who are the least equipped to deal with the devaluation of their savings and wages. The resulting 5,000 percent wage depreciation most certainly will prove more costly to a poor family than to one well off. The reason: The poor devote a far greater percentage of their wages to the purchase of essential goods and services such as basic food, clothing, and housing. Among the poor, pensioners and those with fixed incomes also suffer because they tend to be elderly and thus less able to adapt to the unfamiliar workings of a market economy, and therefore less able to supplement their income through private-sector entrepreneurial activity.

"Shock therapy" works when it is tried. Unlike Russia, Poland and Czechoslovakia have tried "shock therapy"—and the results have been far from impoverishing the nation. Unlike Russia, Poland and Czechoslovakia enacted such far-reaching economic measures as rapid price and trade liberalization; privatization, particularly of small shops, restaurants, and retail-trade outlets; legal and fiscal incentives to spur new private-sector production; and tight control of the money supply.[10] As a consequence of these reforms, the economic situation in Poland and Czechoslovakia today is far superior to that of most East European countries.[11]

9 Gerald Nadler, "Yeltsin to stop Russia's 'dollarization,'" *The Washington Times*, October 7, 1992; "New Decree Tries to Strengthen Ruble," *Commersant: The Russian Business Weekly*, #44, November 3, 1992, p. 5. [The actual decree—Presidential Decree No. 1306, October 27, 1992—is published on page 26.]

10 William D. Eggers, "Economic Reform in Eastern Europe: A Report Card," Heritage Foundation *Backgrounder* No. 893, April 23, 1992.

11 Richard W. Judy, "The Czech and Slovak Republics: Two paths for Eastern Europe," *Hudson Country Report*, Number One, August 1992, Hudson Institute, Indianapolis, Indiana; Richard W. Judy, "Prospects for Economic and Political Freedom in Poland," *Hudson Country Report*, Number Two, December 1992, Hudson Institute, Indianapolis, Indiana; Val Samonis, "Poland's Big Bang: Lessons from the First Three Years," *Geonomics*, The Geonomics Institute, Middlebury, Vermont, September/October 1992, pp. 6-8; Valdas Samonis and Csilla Hunyadi, *Big Bang and Acceleration: Models for the Post-Communist Economic Transformation* (Commack, New York: Nova Science Publishers, 1992).

Private-sector growth and development in Poland and Czechoslovakia dwarfs that of Russia and the countries of Eastern Europe. And inflation in Poland and the Czech and Slovak Republics is but a fraction of what it is in Russia. For example, last year the general inflation rate in Poland was less than 50 percent and in Czechoslovakia, no more than 25 percent. In Russia, by contrast, inflation now is running at a rate of more than 50 percent a month. As for unemployment, it has proved more troublesome but has yet to exceed 14 percent in Poland, 13 percent in Slovakia, and 4 percent in the Czech Republic.[12] Analysts, however, insist that at least one-third of the reported unemployed are actually working in the country's nascent private sector.[13] The reason: both the Polish and Czechoslovakian governments have taken significant steps to protect and promote new private-sector entrepreneurial activity. This has resulted in a dynamic and growing private sector able to provide jobs to workers displaced by the collapse or privatization of state enterprises.

Myth #3: The decline of Russia's industrial sector and the rise of small shops and retail-trade outlets is bad for the Russian economy.

One of the main reasons the government has proceeded slowly with economic reform is its fear that too rapid a transition to the free market will endanger Russia's large state enterprises. According to this line of argument, Russia's greatest economic asset is its industrial capacity, which must be preserved during its transition to a free-market economy. As Viktor S. Chernomyrdin explained last December, soon after his appointment as Prime Minister:

> Our country, with its powerful infrastructure, with such wealth and resources, must not become a country of small shopkeepers.... I'm for the market, and I'm for the economy. But I'm not for a bazaar. No reform can work if we totally destroy industry.[14]

Chernomyrdin's viewpoint is based on misconceptions. Modern economies increasingly are service- and information-based. They are driven not by large, mass industrial production, but by small-scale, high-tech entrepreneurial activity. Indeed, the overwhelming majority of new jobs in the West are created by small businesses, not large factories.[15] This is because the modern high-tech revolution and the increasing interdependence of national economies have resulted in smaller and more efficient modes of production than that which were common in the 19th century. Therefore, the

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12 Judy, "The Czech and Slovak Republics," *op. cit.*; Judy, "Prospects for Economic and Political Freedom in Poland," *op. cit.*

13 Eggers, *op. cit.*; David Lipton and Jeffrey Sachs, *Prospects for Russia's Economic Reforms* (Washington, D.C.: The Brookings Institution, 1993). Otto Ulc, "The Bumpy Road of Czechoslovakia's Velvet Revolution," *Problems of Communism* May-June 1992, p. 23.

14 Serge Schmemann, "Yeltsin Abandons His Principal Aide to Placate Rivals," *The New York Times*, December 15, 1992.

15 David Birch, *Job Creation in America: How our Smallest Companies Put the Most People to Work* (New York: The Free Press, 1987); "Derailing the Small Business Job Express," Prepared for Representative Richard Armey, Ranking Republican, Joint Economic Committee, United States House of Representatives, November 7, 1992; Scott Powell, "The Entrepreneur as the Mainspring of Economic Growth," Hoover Institution, Stanford University, 1990.

success of a market economy today depends on a thriving service and information sector or "bazaar," as Chernomyrdin calls it.

For Russia to continue to divert scarce resources to hopelessly uneconomic industries will not ensure prosperity but only continued poverty. Among the reasons: It will mean the production of more excess tanks, heavy machinery, trucks, and aircraft, most of which are overpriced and lacking in market value and most of which, therefore, the Russian people cannot use for domestic purposes or for foreign trade. It will mean a continuation of subsidies and credits to state industry and the crippling high inflation that necessarily accompanies a loss of control over the money supply. And it will mean a conspicuous shortage, in both number and variety, of basic consumer goods, food, and housing.

Benefits of the "Shopkeeper" Economy. While the inefficient state-run industry should not be saved at any cost, neither should the "bazaar" to which Chernomyrdin refers be restricted. Free-market economies grow from the bottom up, not the top down. They develop precisely because of the thousands upon thousands of small shopkeepers and traders who profit by helping their customers obtain needed goods and services. Indeed, as the history of economic development in the U.S., Western Europe, and other industrial countries shows, the profits that accumulate from these small but important ventures are the source of most of the capital needed for the development of modern, high-tech industry.[16]

China provides an illustrative example. Household savings in China now account for some 70 percent of the funds used to finance new investment;[17] as a result, Chinese gross national product grew at an average annual rate of 9 percent between 1978 and 1988.[18] This rise is attributable almost entirely to growth in the nascent, small-scale Chinese private sector, which now accounts for more than 45 percent of total industrial output, up from only 23 percent in 1979. And if agricultural production and the service sector are factored into the equation, the private sector accounts for at least 75 percent of total economic output in China.[19]

In contrast, the state-run heavy industries built by the Chinese communists have contributed nothing to China's rapid economic growth over the past decade. In fact, virtually all of the state-owned enterprises—up to 90 percent of them—are operating in the red. Far from being a crucial element of prosperity, these enterprises are a drag on the economy. Thus, the Chinese government is looking actively for ways to dismantle the worst performers and transfer those which are salvageable to the private sector.

Not only China, but Poland and Czechoslovakia have used small-scale private-sector entrepreneurial activity to precipitate an economic "miracle." The nascent private business sectors in these countries are responsible for strong, export-led recoveries. In

16 L.E. Birdzell, Jr., *How the West Grew Rich: The Economic Transformation of the Industrial World* (New York: Basic Books, Inc., 1986).

17 Sir Alec Cairncross and Dr. Cyril Zhiren Lin, "The private sector that is driving China," *Financial Times*, January 8, 1993.

18 Goldman, *op. cit.*, p. 86.

19 Cairncross and Lin, *op. cit.* "When China Wakes," *The Economist*, November 28, 1992.

Poland, for example, exports have nearly doubled from some $8 billion a year in the pre-reform year 1989 to approximately $15 billion a year in 1992.[20] In Poland's first year of reform—1990—a $4.5 billion trade surplus was registered with Western Europe.[21] More important, the private sector's share of Polish exports has risen dramatically, from 4.9 percent in 1990 to more than 21.9 percent in 1991, and is still growing.[22]

Similarly, in Czechoslovakia, first quarter 1992 exports grew by 17 percent while exports to market-oriented economies grew by more than 45 percent. The marked rise in Czech exports is especially noteworthy because Czechoslovakia was more dependent on trade with other Soviet-bloc countries than was any other East European country.[23]

Economic recovery in Poland and Czechoslovakia has been driven by spectacular growth in small-scale private-sector entrepreneurial activity. The nascent Polish private sector, for example, now accounts for approximately 45 percent of the country's GDP, up from only 28.4 percent in 1989.[24] However, because of the existence of a vast "underground" economy in Poland, the private sector's contribution to total Polish GDP is actually much greater, perhaps as high as 60 percent.[25] All told, during the past three years of reform, the Polish private-sector has created some two million new jobs. It also has launched 50,000 new corporations and 700,000 small businesses that, all together, employ more than 55 percent of the work force.[26]

Similar developments have taken place in Czechoslovakia. Private retail-trade turnover grew from 10 percent of all retail-trade turnover at the end of 1990 to 40 percent in 1991. Moreover, the number of registered private entrepreneurs nearly tripled in 1991, from 488,000 to 1.34 million.[27] And, primarily because of the privatization of retail trade, retail sales in Czechoslovakia have soared, growing by 27 percent in the first nine months of 1992.[28]

Significantly, economic growth in both Poland and Czechoslovakia has not come at the expense of inflation or unemployment. In Poland, inflation actually has fallen from an annual rate of nearly 600 percent in the pre-reform year 1989 to less than 50 percent in 1992.[29] In Czechoslovakia, after a one-time rise in the price index of 25.8 percent in January 1991, the quarterly inflation rate has stabilized at a rate of less than 3 percent.[30] Unemployment has proven to be even less of a problem, running at a rate of little more than 7 percent in Czechoslovakia[31] and 13.5 percent in Poland.[32] Analysts and officials

20 Samonis, *op. cit.*
21 Eggers, *op. cit.*
22 Judy, "Prospects for Economic and Political Freedom in Poland," *op. cit.*
23 Judy, "The Czech and Sloval Republics,*op. cit.*
24 Judy, "Prospects for Economic and Political Freedom in Poland," *op. cit.*
25 *Ibid.*
26 *Ibid.*; Samonis, *op. cit.*
27 Judy, "The Czech and Slovak Republics," *op. cit.*
28 Richard L. Holman, "Postcripts...," *The Wall Street Journal*, November 5, 1992.
29 Judy, "Prospects for Economic and Political Freedom in Poland," *op. cit.*
30 Judy, "The Czech and Slovak Republics," *op. cit.*
31 *Ibid.* However, the unemployment rate has been higher in Slovakia than in the Czech Republic. In 1991, for example, the unemployment rate was only 4.1 percent in the Czech Republic, but 11.8 percent in Slovakia.

in both countries, however, say these figures overestimate the actual jobless total by at least a third since they include as unemployed many people who actually have jobs in the private sector.[33]

Strengthening and Restructuring Russian Industry. Far from destroying Russian industry, radical economic reform is necessary to save it. Only by its forced restructuring and adaptation to world market conditions can Russian industry be modernized and begin producing goods useful to the Russian consumer.

Once again the examples of Czechoslovakia and Poland are illustrative. As the reform governments in these countries have cut back on subsidies to the old state industrial sector, the result, to be sure, has been a decline in heavy industrial production. But as the inefficient state-run industries decline, they consume less credit, subsidies, and other financial resources. This frees scarce resources and capital for new private-sector development, which has grown dramatically in both Poland and Czechoslovakia during the past three years of reform. Private industry in Poland, for instance, now accounts for some 40 percent of Polish GNP, up from 11 percent during the first year of reform. And if private farm production is included in the tally, the private sector will account for more than 50 percent of GNP in Poland in 1992.[34]

A comparable withdrawal of subsidies and credits to the old state industrial sector has not yet occurred in Russia. A substantial cut in state subsidies and credits to industry was attempted in the first quarter of 1992, but quickly abandoned in the face of strong political opposition. Consequently, the decline of industrial production in Russia has lagged behind that of Poland, Czechoslovakia, and other countries now in transition to a market economy. The result, naturally, has been a meager private sector, one that, to be sure, is growing, but only at a very slow pace and with many accompanying difficulties.

The Russian military-industrial complex, by contrast, continues to enjoy a plentiful supply of resources. But with the collapse of communist rule and the end of the Cold War, Russia has no need for the massive Soviet military establishment. Nor need it retain the wasteful and antiquated industrial operations which made it , for example, the world's largest steel producer, with a steel output per dollar of GDP fifteen times higher than that of the U.S., eight times higher than that of West Germany, and seven times higher than that of Japan. Most of the Soviet steel, of course, was used to produce military hardware, not consumer goods.

A reduction of subsidies and credits to state-owned industry is, in fact, the key to a stable fiscal and monetary policy in Russia. It will lead to the collapse of wasteful and inefficient state enterprises which cannot adapt to an environment of fiscal and monetary restraint. But not all enterprises will go bankrupt in the wake of a comprehensive and full-fledged economic reform program. Some will make the necessary changes and work to harness the newly emerging market forces now at work in Russia.

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33 Eggers, *op. cit.*; Lipton and Sachs, *op. cit.*; Ulc, *op. cit.*

34 Samonis, *op. cit.*

In fact, a growing number of state enterprises are already adapting to the new conditions of the market.[35] Some state enterprises are seeking out foreign partners and investors by shifting to new modes of production and by selling off worthless assets. Clamping down on the reform process and slowing it, all in the name of "saving Russia's industrial sector," would only hamper these necessary changes and thus would do great damage to the Russian Federation's future industrial capacity and potential. Indeed, by reducing the incentive to restructure, a slowing of reform would lead to further waste of Russia's scarce economic resources and delay modernization of its industry.

The way to save Russia's industrial sector is not to insulate industry from the market and maintain the flow of credits to loss-making state enterprises; rather, it is to press ahead with the government's program of mass privatization. Once Russian industry is in private hands, it will become increasingly responsive to the market and thus to the needs of the people. Businessmen then will respond to the requirements of the market, and not to bureaucrats attuned to the political demands of entrenched interests.

Even those enterprises that close down will nonetheless be salvaged through their sale to private-sector businessmen and investors. In some cases, parts of the defunct enterprise will be adopted by a new, more prosperous enterprises and incorporated into a more profitable line of production. In other cases, the enterprises will be broken down into their constituent, raw material parts, which then can be used for trade and development in new market ventures. Regardless of exactly what becomes of the enterprise, however, Russia will not suffer an economic loss. Quite the contrary, it will enjoy a net gain, as credit, capital, and other scarce financial resources are put to more efficient and productive use.

This process of "creative destruction" is messy and untidy. It creates rapid change and uncertainty, and results in some temporary unemployment as state enterprises are restructured and incorporated into the newly emerging market economy. But the appropriate response to this inevitable development is not to step back from reform; rather, it is to push ahead with reforms to create new private-sector jobs for workers as quickly as possible.

Myth #4: Russia's unique history and culture make it an inhospitable environment for the development of Western-style entrepreneurial capitalism.

Consequently, it will have to find its own "third way" that is neither socialist in the Bolshevik sense nor capitalist in the American, West European, or Japanese sense.

Russia indeed has a history and culture that differ markedly from those of the U.S., Western Europe, and Japan. Most obviously, it has had over seventy years of Communist rule, which repressed entrepreneurs who refused to abide by the ban on private-sector trade and initiative. Moreover, it is commonly asserted that, unlike the U.S. and Western Europe, Russia was relatively untouched by the Renaissance, the Enlightenment, and

35 See, for example: Kathryn Hendley, "Steps on the Road to Privatization: A Preliminary Report on the Saratov Aviation Plant," Center for International Security and Arms Control, Stanford University, June 1992; Laurie Hays, "Russian Plant Weans Itself from Military: Consumer Goods, Airliners Spell Success for Saratov," *The Wall Street Journal*, January 5, 1993.

other important historical stages common to the West, and thus its culture supposedly lacks an appreciation of the importance of entrepreneurship, private property, self-rule, and democracy.

The view that Russian culture would never permit Russia to become a democracy was an article of faith among Western academics and area specialists until the events of 1991. Surprisingly, this view was as common in Russia as in the West. Similar pronouncements continue to be made, by Westerners and Russians alike, that Russia can never be capitalist.

But the Russian people themselves disprove this assertion. Russians embrace the values of the market every day. They show by their involvement in the "bazaar" economy that history moves on, that Russians are capable of overcoming their burdensome past. They show that Russians indeed are capable of capitalism.

Japan and the "Asian Tigers." A look at the spectacular rise of entrepreneurial capitalism in Japan after World War II is illustrative. Like Russia, Japan has a unique history and culture that differ markedly from that America and Western Europe. But every country has its own history and culture that influence the ways in which it embraces democratic and free-market institutions. But history and culture in themselves need not pose an insuperable obstacle to the market and democracy. Japan, for example, never passed through the Renaissance and the Enlightenment; yet, democratic and free-market institutions now flourish there.[36]

Similarly, Western economists commonly asserted in the 1950s and 1960s that capitalism was inappropriate for the peoples of Asia because they had a "Confucian" ethic that did not value the "rugged individualism" and competitive spirit of the free market.[37] Yet, today the literature on economic development is filled with references to the important role of the Confucian ethic in the "miraculous" rise of the "Asian Tigers": Hong Kong, the Republic of China on Taiwan, the Republic of Korea, and Singapore.[38]

36 Sachs and Lipton, *op. cit.*, note that according to Henry Rosovsky, author of "Japan's Transition to Modern Economic Growth, 1868-1885," "foreign observers.... were extremely pessimistic" about the fate of capitalism in Japan and other nations of the Orient: "With considerable complacency they wrote: 'Wealthy we do not think it will ever become: the advantages conferred by Nature, with the exception of the climate and the love of indolence and pleasure of the people themselves forbid it.' Or, 'The national banking system of Japan is but another example of the futility of trying to transfer Western growth to the Oriental habitat. In this part of the world principles, established and recognized in the West, appear to lose whatever virtue and vitality they originally possessed and to tend fatally towards weediness and corruption.'" Henry Rosovsky, "Japan's Transition to Modern Economic Growth, 1868-1885," *Industrialization in Two Systems: Essays in Honor of Alexander Gerschenkron*, edited by Henry Rosovsky (New York: John Wiley & Sons, Inc., 1966).

37 Yaichi Itagaki, "Economic Backwardness and the Theory of Economic Development," *Far Eastern Economic Review*, February 19, 1957; P.C. Spender, "Partnership with Asia," *Foreign Affairs*, January 1951; Peter L. Berger and Hsin-Huang Michael Hsiao, *In Search of an East Asian Development Model* (New Brunswick: Transaction Books, 1988).

38 Tom Bethell, "The Riches of the Orient," *National Review*, November 7, 1986; Berger and Hsiao, *op. cit.*; Lawrence J. Eau, ed., *Models of Development* (San Francisco: The Institute for Contemporary Studies, 1986); "Where Hong Kong has the Edge," *The Economist*, August 22, 1992, p. 26.

History and culture are, to be sure, important. In particular, they can create a formidable array of political obstacles to reform. For example, groups benefitting from the old, anti-market ways of doing business seek to preserve their protected status in society by sabotaging and turning back reform. Certainly, this is true in Russia today, where many of the old *nomenklatura* act as a strong political force that works against greater change.

But a country's history and culture, no matter how hostile to democratic and free-market institutions, cannot extinguish the universal aspirations of people everywhere to be free and to live a better life. For example, in a 1992 Russian public opinion survey, more than 80 percent of the respondents who were 29 years old and younger agreed that "an enterprise is best run by entrepreneurs producing goods people want." Sixty-four percent of those between the ages of 30 and 59 preferred private enterprise to state-run business.[39] A new generation of Russians are already unlearning the lessons of the past, and learning valuable new lessons for the future—how to survive in the marketplace.

The Emergence of the Russian Private Sector. None of this is surprising in the wake of either recent Russian experience or more distant Russian history. With the recent emergence of hundreds of local commodities markets throughout the country, for example, Russia has witnessed a marked rise in entrepreneurship the past few years. Indeed, official government statistics show that the percentage of the Russian work force employed by state firms has dropped from 91.1 percent in 1985 to 82.4 percent in 1990 to 77.2 percent in 1991.[40]

According to a 1992 Central Intelligence Agency (CIA) report, the emerging private sector in Russia "now constitutes about 20 percent of GNP and employs more than 15 percent of the Russian work force."[41]

Some 25 percent of Russia's housing stock, the CIA report notes, has been "financed privately by citizens and was never part of state inventories." Twenty percent of Russian industrial output in 1991 was produced by semi-private enterprises, "primarily firms that were leased from the state" and run by autonomous entrepreneurs. And nearly half of all building construction was done by cooperatives or leaseholdings. According to the CIA report, leased enterprises or leasholdings "tend to be among the top performers in the economy because workers are usually given [market-oriented], profit-sharing incentives." And although Russian cooperatives have strong ties to state enterprises, the CIA notes that they "behave in many ways like independent, [private-sector] businesses: They offer salaries linked to productivity and seek out new customers and avenues of enterprise."[42]

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39 Irina Boeva and Viacheslav Shironin, "Russians Between State and Market: The Generations Compared," *Studies in Public Policy*, No. 205, Centre for the Study of Public Policy, University of Strathclyde, Glasgow, 1992.

40 Lipton and Sachs, *op. cit.* These statistics accurately gauge a trend of decline in the Russian state sector and growth in the Russian private sector. However, they are only gross approximations of the reality and, as such, underestimate the extent of the changes now taking place in Russia. According to one analyst, for example, authoritative figures from diverse sources show that some 40 percent of the Federation's non-agricultural labor force is employed in Russia's newly emerging private sector, up from only 21 percent one year ago. S. Frederick Starr, "Year One of Capitalism in Russia," speech delivered at a Russian Embassy Seminar, January 15, 1993.

41 Central Intelligence Agency, *op. cit.*

This evidence of private-sector entrepreneurial activity disproves the assertion that Russia is incapable of developing Western-style capitalism. Even the CIA's data underestimate the degree of private-sector entrepreneurial activity now underway in Russia because, as the CIA explains, they "do not include black market or other unreported private economic activities," which are substantial. An estimated 83 percent of the Russian people, for example, now conduct business in the "black" or informal sector of the economy, along with an increasing number of state firms.[43]

Russia's Lost History of Capitalism. The explosion of private economic activity in Russia is no historical accident. In fact, Russia has a capitalist past that is often overlooked. Before the Bolshevik takeover, Russia ranked among the world's fastest growing capitalist economies. Industrial production in 1913 was increasing at an annual rate of 5 percent, roughly the same as in Germany and the United States. National output was about equal to that of Great Britain and only slightly behind that of Germany. And per-capita agricultural production dwarfed that of Britain and compared favorably, and in some cases surpassed, that of the U.S.[44]

Historians cite many reasons for the economic awakening of Russia in the late 19th and early 20th centuries.[45] The most important were the abolition of serfdom in 1861, the dismantling of the collectively tilled farms and the consequent rise of private peasant land ownership, the creation of a stable and reliable "gold-backed" currency from 1897 to 1914, and a massive influx during the same period of foreign capital and investment that opened Russia to Western trade and investment. The process of reform came to a halt in 1914 with Russia's entry into World War I and, of course, was reversed with the Bolshevik takeover in 1917. Soon thereafter, Russian industry was nationalized, central planning begun, and collective farms imposed on the countryside.

This "lost tradition" of entrepreneurial capitalism awaits discovery by the present generation of Russians. But there are some things from the past—even the Communist past—that need not be rediscovered. As Cathy Young, author of *Growing Up in Moscow* explains:

> The notion that Communist states shield people from the need to fend for themselves—whether that is seen as good or bad—could only occur to someone who has no idea what it's like to get a decent apartment or chunk of smoked ham in the [former] Soviet bloc. The energy and ingenuity spent on these pursuits would have generated untold wealth if applied in business. The problem with socialist economies is not that human initiative and enterprise have been stamped out: they have simply been channeled into consumption rather than production.[46]

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42 *Ibid.*

43 Sullivan, *op. cit.*

44 Stanley Fischer, "Russia and the Soviet Union Then and Now," National Bureau of Economic Research, Inc., Working Paper No. 4077, Cambridge, Massachusetts, May 1992; Arcadius Kahan, *Russian Economic History* (Chicago: University of Chicago Press, 1989); Mikhail Heller and Aleksandr Nekrich, *Utopia in Power* (New York: Summit Books, 1986); Alec Nove, *An Economic History of the U.S.S.R.* (London: Pelican Books, 1989).

45 Fischer, *op. cit.*; Kahan, *op. cit.*; Heller and Nekrich, *op. cit.*; Nove, *op. cit.*

46 As quoted in: Melanie S. Tammen, "Kleptocracy-Capitalism in the Soviet Second Economy," *Journal of Economic*

Even in the present post-Soviet reform era, this emphasis on consumption is still very much the case. The problem, however, lies not with the Russian people, who continue to demonstrate extraordinary patience and ingenuity in the face of a bewildering array of state-imposed obstacles to entrepreneurship and private-sector initiative. Rather, the fault lies with a political and economic system that too often punishes individuals for the entrepreneurial activities that are the only hope for Russia's emergence from its post-socialist economic morass.

The answer to this problem is not some mythical "third way" to economic reform; the only effective and viable way to achieve economic growth and prosperity is through an enthusiastic embrace of entrepreneurial capitalism. Only a comprehensive and full-fledged economic reform program, one that removes the bureaucratic impediments to entrepreneurship and private-sector initiative, can accomplish this task.

CONCLUSION

Russia has taken tremendous strides toward economic reform. Indeed, few Western experts thought it could have achieved so much in so short a period of time. Russians have overthrown the communists and begun to embrace democracy and free markets. Private-sector farming and entrepreneurship have grown. And a comprehensive plan for mass privatization of state industry has been developed as well.

Of course, many problems remain. Russia is suffering from hyperinflation, declining energy and industrial production, and a lack of private sector entrepreneurial activity. Because of these problems, many myths have emerged to explain why Russia's economy is floundering. Some say that reform is moving too fast. They argue that the policy of "shock therapy" is mainly responsible for Russia's economic troubles. Others contend that free market reforms are destroying Russia's industry. And some experts insist that entrepreneurial capitalism as it is known in the United States, Western Europe, and Japan cannot succeed in Russia. Indeed, say the experts, Russia has a history and culture that differ markedly from each of these three countries and regions and thus must find its own, unique "third way" to prosperity that is neither socialist in the Bolshevik sense nor capitalist in the American, West European, or Japanese sense.

These experts are wrong. "Shock therapy" has not been tried in Russia. Where it has been tried—in Poland and Czechoslovakia—it is largely succeeding. Moreover, the decline of Russia's state-owned industrial enterprises is not only a necessary development, but a welcome one that frees resources for the private sector. Finally, Russia's historical legacies are not wholly hostile to the rise of capitalism. In fact, to the extent that it has been given the opportunity to develop and flourish, entrepreneurial capitalism has already proved remarkably vigorous in Russia.

The problem in Russia today lies not with the Russian people. The problem is that Russians have been given too few opportunities and incentives to create a growing economy. The solution to Russia's economic problem is not less reform, but more

Growth, Vol. 4, No. 3, December 1990; Cathy Young, "Creeping Capitalism in Soviet Russia," *The American Spectator*, March 1990, p. 12.

reform. The government should press ahead quickly with a comprehensive and full-fledged economic reform program that would include continued mass privatization of state industry; a complete freeing of prices, particularly on energy products; a thorough program of land reform and agricultural privatization, which would include an unambiguous legal right to private land ownership and the elimination of preferential subsidies to collective farms; construction of a legal regime that protects private property rights and includes market-based laws governing such things as ownership, corporations, labor, pensions, bankruptcy, banking, monopolies, and taxation; a stable fiscal and monetary policy; trade liberalization; small-scale privatization; and currency convertability.

Economic reform, moreover, should be carried out in a wholesale and not piecemeal manner. Russia's economy cannot be expected to function when superficial and half-hearted reforms are imposed on top of a dying command and control economic system. "Shock therapy" is, in fact, the reform strategy that has been implemented successfully by Polish and Czech reformers, who have steered their countries into the beginning of a profound and long-term economic recovery. Russia can duplicate their feat, but to do so it must disregard the doubts and mythical objections of those who misunderstand not only Russia but the human spirit. History's only proven path to economic growth and prosperity is capitalism with no adjectives and entrepreneurship with as few restrictions as possible.

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