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AN AGENDA FOR THE NEW RUSSIAN PARLIAMENT, PART I: ECONOMIC ISSUES

INTRODUCTION

The new Russian Parliament faces three choices on economic reform: 1) to continue on the course laid down by President Boris Yeltsin; 2) to delay or even reverse reforms; or 3) to enact market reforms far more sweeping than envisioned by Yeltsin, who despite charges to the contrary by his critics, has been slow to introduce the basic building blocks of a market economy.

The first choice, staying on course, is not working. Yeltsin's economic policies have the appearance of radicalism, but in reality they are quite modest. Far from being "shock therapy," Yeltsin's economic policies have destroyed the old economic system without creating a new one to replace it. Russia does not yet have a market economy. It has a collapsing command and control economy. One of Yeltsin's biggest political failures has been his inability to counter the widespread perception, created by his enemies, that the cause of Russia's economic misery is the failure of Russia's nascent market economy—in a word, the failure of capitalism.

The second choice, advocated by communists, centrists, and even some reformers, will produce further economic stagnation and more misery. Propping up the old and dying communist economic system by slowing reforms is essentially an admission of defeat, a choice without hope, and a decision that will simply prolong the agony of the Russian people. Attempting to restore the old command and control system would be even worse. Doing so would require not only the imposition of totalitarian rule, but a perpetuation of the disastrous economic practices that brought Russia to the brink of economic catastrophe in the first place.

Russia's only hope is the third choice: sweeping and fundamental reform. Creating a market economy as rapidly as possible is the only way that Russia can escape the abyss. Thus, a new economic policy must go beyond Yeltsin's rather timid policies of price liberalization and privatization. Essentially, it means destroying the monopoly system of

inefficient state-run industries, creating ironclad laws and favorable conditions for the operation of a market economy, and establishing a temporary safety net for people dislocated by the collapse of the old economic system.

Following this course will be difficult. Russia is beset with deep and persistent problems, including near hyperinflation, a lack of job opportunities in the private sector of the economy, crime and corruption, a near worthless currency, and an antiquated and inadequate infrastructure of roads, bridges, and airports.

Historic Opportunities. This can and must change. Russia must realize its true economic potential and take its rightful place as an international leader and engine of world-economic growth and development. To do this, the new Russian Parliament must enact very rapidly a comprehensive program for economic growth and development for the Russian nation and its people. There are four essential pillars to an economic growth agenda.

Pillar #1: Entrepreneurship. Entrepreneurship creates prosperity and economic growth. Although the government itself cannot produce an entrepreneurial economy, it can create the conditions in which one can grow. Thus, to do this, the new Russian Parliament should:

- ✓ **Eliminate punitive and confiscatory rates** of taxation on savings, work, and investment;
- ✓ **Maintain a sound and reliable currency**, preferably through a currency board;
- ✓ **Encourage the growth of an educational and social culture** that celebrates rather than denigrates entrepreneurship.

Pillar #2: Rapid job creation by the private sector. Entrepreneurs create new jobs. These jobs not only support people, they provide revenue to the state. Jobs created by the government, however, are a drain on the economy because they must be supported by taxes. To spur the growth of private-sector jobs, the new Russian Parliament should:

- ✓ **Eliminate punitive rules and regulations** that make it unprofitable for entrepreneurs to create new jobs and hire more workers;
- ✓ **Subject proposed rules and regulations to a jobs test**, in which studies are conducted to assess the impact of a proposed rule or regulation on private-sector jobs;
- ✓ **Expand the privatization of state housing;**
- ✓ **Establish unemployment compensation and retraining programs** for workers displaced by the privatization of state-owned enterprises.

Pillar #3: A free and open market. To be successful, entrepreneurs need access to a free and open market, whose operation is not stifled by government coercion and control. To facilitate the development of such a market, the new Russian Parliament should:

- ✓ **Establish a legal framework that secures and protects private property rights;**

- ✓ **Eliminate special subsidies and credits to state and collective farms.** They discriminate against private farmers;
- ✓ **End tariffs and other trade restrictions,** including import subsidies, export quotas and export controls and licensing;
- ✓ **Develop private property rights, contract laws, and a tort system** to deepen and broaden the privatization process.

Pillar #4: Growing and dynamic capital markets. The venture capital need for risk-taking entrepreneurs can best be filled by the private sector. To create an economic climate conducive to capital creation and investment, the new Russian Parliament should:

- ✓ **Permit foreign banks to operate freely in Russia;**
- ✓ **Privatize the Russian banking sector;**
- ✓ **Reduce taxes on working people** so that they have more money to save and invest.

RUSSIA'S ECONOMIC CRISIS

As the success of extreme nationalists in the recent parliamentary elections shows, Russians are fearful of the future. This is understandable. High inflation—rates on the order of more than 2,000 percent last year—has raised their cost of living and depleted their savings. Millions of citizens are out of work and face few employment prospects in the Russian private sector. With organized crime groups (dubbed the mafia) dominant in many towns and cities, crime and corruption are rampant. In fact, a large percentage of the new entrepreneurs in Russia are old-line *apparatchiki* exploiting their privileged positions of public power for personal gain. Most Russians have no confidence that this state of affairs will change any time soon.

“Shock Therapy?” As bad and intractable as Russia’s economic problems are, however, they could be much worse. Indeed, were it not for the leadership of President Yeltsin and other free-marketeers, Russia could well be another Ukraine: on the verge of economic collapse, with a worthless currency, and average wages a fraction of what they are in the Russian republic.

Although Russia has serious problems, much progress has been made. For example, more than 80,000 state enterprises have been privatized, including virtually all small shops, restaurants, and retail trade outlets. An increasing number of these enterprises are responding to fledgling market forces now at work in Russia and thus are making the transition from industrial and military production to consumer goods production. A plentiful supply of most goods is now available to consumers. And inflation, albeit very high, has nonetheless been contained to less than hyperinflationary levels. By December 1993, for instance, the monthly inflation rate in Russia had been brought down to 20 percent, from a high of nearly 50 percent or more at the beginning of the year.¹

More important, the Russian private sector has grown dramatically since early 1992. The private sector accounts for nearly 40 percent of Russia’s gross domestic product and more than 40 percent of part-time and full-time employment. The number of private-sec-

tor farms alone has grown from a meager 1,000 in 1990 to nearly 300,000 today.² The reason: private-sector trade has been legalized, while state industry has been partly privatized. This has granted greater autonomy and freedom of action to enterprises and enterprise directors.

Far from being the cause of Russia's present economic woes, these policies are the cause of whatever success Russians now enjoy. Russia's problems are not the result of too much change pursued too quickly; they come from a reluctance to fully scrap the left-over socialism in the economy. Thus, those who argue against "shock therapy" for the economy are wrong; shock therapy has not yet been applied, and is long overdue.

For example, the government continues to subsidize state industry heavily. Monetary growth is unpredictable and erratic, alternating between bouts of modest restraint and wild inflationary expansion. In recent months, the inflation rate has dropped as a result of tighter monetary policies. These efforts to stabilize the ruble need to be strengthened. But many other problems remain. Private-sector initiative remains heavily regulated and restricted by the state. Private property rights lack adequate legal protection. And Russian tax rates are still onerous and burdensome.

Misleading Election Results. Despite the strong showing of ultranationalist Vladimir Zhirinovskiy in the parliamentary elections, most Russians understand that more reforms are necessary. Indeed, when asked in an exit poll, "Which is closer to your view?: 'I want the current economic reforms to continue' or 'I want the economic reforms slowed down,'" 70 percent of respondents said that they want the current economic reforms to continue.³

This is not surprising. Just last April, after all, a majority of Russians went to the polls to support President Yeltsin. At that time as well, a clear majority of Russians approved of his economic policies. The new Russian parliament must recognize this reality and faithfully represent the collective will of the Russian people, which is for more, not less, free market change.

The presence of communists and hard-line nationalists in the new Russian parliament is not an indication of the Russian people's dissatisfaction with tearing down communism and building a free market. Rather, it is an indication of their dissatisfaction with too little progress. They are unhappy with the dismal performance of the economy, which is not a market economy but a collapsing command and control economy.

A parallel can be drawn with recent election results in Italy, where both the far left and far right gained at the expense of the democratic center. Italians, like Russians, were not expressing a desire for communism and fascism; rather, they were voting for change and against the status quo. Theirs was a protest vote. So, too, was the Russian vote of around 49 percent for communists and ultranationalists in the December parliamentary elections.

1 "Cruel to be kind," *The Economist*, December 11-17, 1993, p. 24.

2 Roy L. Prosterman and Leonard J. Rolfes, Jr., "Status Report on Russian Agrarian Reform," RDI Reports on Foreign Aid and Development #80 (Seattle, Washington: Rural Development Institute, March 31, 1993), p. 2.

3 The poll was conducted by Mitofsky International/Institute for Comparative Social Research. The results were reported in Margaret Shapiro, "Russians Approve New Constitution," *The Washington Post*, December 13, 1993, p. A1.

Russians understandably yearn for their country to be a great international power and for their standard of living to improve. Zhirinovsky and other ultranationalists exploited this sentiment and profited from it. But what they promised can be attained only through economic growth, which Zhirinovsky and other enemies of the market cannot deliver. Indeed, economic growth can be attained only by unleashing market forces. The nationalist, anti-growth policies of Zhirinovsky can only bring further economic ruin to Russia.

FORGING A PATH TO GROWTH

Reform will be difficult but not impossible. The key to success is for the leaders of the reform parties in the parliament to put aside personal and parochial differences for the greater good of the Russian nation and its people. If that is done, then reforms will be successful. History offers many examples of successful market reforms. In Chile, market reforms in the 1980s were successful, laying the groundwork for the rebirth of democracy in that country. And while democracy has not yet come to China, reforms there have let loose a mighty torrent of economic growth. These examples show that any successful reform program must be based on four pillars.

Pillar #1: Entrepreneurship.

No country in the history of the world has ever grown rich and prosperous without entrepreneurship, which can be defined as business activity undertaken voluntarily by individuals, or associations of individuals, who assume sole responsibility for the success or failure of their actions. China, for example, has had an astounding growth rate of nearly ten percent or more per year for the past ten years. The reason: a conscious decision by the government to free up certain sectors of the economy, which has unleashed the entrepreneurial flair of the Chinese people. Indeed, Chinese economic growth stems not from state industrial production, but from the entrepreneurial efforts of millions of hard-working Chinese operating independently of their government.

“Trade Capitalism.” Russians are no different. Like their Chinese counterparts, millions of Russians have taken to entrepreneurship and thus engage in the sale and trade of a wide variety of consumer goods, including food, clothing and hardware. Witness, for example, the spectacular growth of the kiosks—small shops and trading outlets. Virtually unknown to most Russians three years ago, kiosks now line the streets of most Russian towns and cities, selling an assortment of goods and services.

Very few Russian entrepreneurs produce the goods that they sell; instead they buy them from Russian state enterprises or import them from abroad. This type of “trade capitalism” is the earliest and most necessary step taken on the road to economic growth and development. Profits made this way provide the start-up capital needed for more advanced forms of entrepreneurial activity. Indeed, many of the trade capitalists of today will become the venture capitalists of tomorrow, providing capital to fuel new economic activity and becoming the captains of advanced industry.

The new Russian parliament must encourage their efforts and create an economic climate conducive to entrepreneurship. Therefore, it should enact legislation that:

✓ **Eliminates punitive and confiscatory rates of taxation on savings, work, and investment.**

Russian tax rates are among the highest in the world. A Russian entrepreneur is often subject to an effective cumulative tax rate of 100 percent or more, although a tax rate of at least 70 percent is more typical. This discourages Russians from working, saving, and investing. And it forces honest Russian businessmen underground into the black market, where they inadvertently strengthen the hand of the Russian mafia and deprive the national treasury of revenue.

If Russians do not work, save, and invest in their country's private sector, then the Russian economy will not grow. Tax rates, therefore, must be radically reduced and simplified to an effective cumulative rate of no more than 25 percent. Western economists have found that taxation in excess of that amount depresses entrepreneurial activity, retards economic growth, and reduces tax revenue.

History shows that low-tax countries enjoy significantly higher growth rates than high-tax countries. This was certainly the experience during the 1980s in the United States. Ronald Reagan's income tax reductions in 1982 set off the longest period of continuous peacetime economic growth in America's history.

✓ **Introduces and maintains a sound and reliable currency, preferably through a currency board.**

The value of a currency must remain steady and predictable. Otherwise, entrepreneurs will lack confidence in it and shun its use. This already has happened with the Russian ruble, which has collapsed in value by more than 1,000 percent since early 1992. Consequently, Russian entrepreneurs are embracing the dollar instead of the ruble.

Russians will continue to use the dollar until a stable national currency exists. A stable currency cannot be created until the Russian government stops the explosive growth of government spending that fuels inflation and devalues the ruble. Thus, as a first step toward creating a stable currency, the Russian government must dramatically cut back on government subsidies to state-owned industries. These subsidies are financed by deficit spending and by printing rubles notes, which drive up the inflation rate.

This problem can be averted by establishing a Russian monetary system independent of direct political control. The independence of such a system is essential; without it, the Russian Central Bank will be forced to accommodate intensifying political demands for more spending, subsidies, and credits. The U.S. Federal Reserve System and German Bundesbank are exemplary models of precisely how such a system should be set up and how it should operate. Managed by professionally trained economists whose appointments transcend political election cycles, these banks are more attuned to the monetary needs of the market than are the political demands of entrenched interests

Currency Board. There is, however, serious doubt as to whether an independent central bank could be established soon in Russia. Never in its history has Russia had an independent central bank. The complex nature of monetary systems requires a level

of economic training and sophistication now lacking among most Russian economists and bankers.

For that reason, economists such as Steve Hanke and Kurt Schuler of The Johns Hopkins University suggest a bold, alternative approach: introduction of an independent currency board, which would issue notes and coins backed directly by a foreign currency.⁴ Entrepreneurs and workers could exchange these notes and coins for dollars at a fixed rate. The amount of money issued would vary depending on their needs. In any case, because of its independence and market-oriented nature, a currency board would not be subject to government-induced inflationary pressures. The result would be a sound and reliable Russian currency fully convertible on world markets.

✓ **Encourages the growth of an educational and social culture that celebrates rather than denigrates entrepreneurship.**

American and West European economic success owes much to the existence of a Protestant work ethic that values hard work and frugality. Likewise, the economic success of Japan, China, and East Asia owes much to the Confucian ethic, which subordinates individual desire to the good of the society. Both of these ethics celebrate entrepreneurship and articulate the belief that personal economic success is a good thing.

The Russian government can foster such an ethic by supporting civic and cultural institutions that champion hard work, individual responsibility, and personal achievement. Parents, for example, should be allowed to educate their children at religious schools, even at public expense. A religious education performs an important public and secular goal: it inculcates such values as self-discipline and hard work that produce healthy economies.

Similarly, the Russian government should safeguard the new constitution's protection of religious freedom and it should extend official legal recognition to religious holy days. Doing this would send a strong signal to the Russian people that religious values are important to the Russian nation. And it would help foster an ethos of respect for those values, without which any nation cannot long endure.

Moreover, to the extent that the Russian government subsidizes higher education and other scholarly pursuits, it should support those scholars and institutions dedicated to the study of the moral and ethical foundations of capitalism, particularly within the context of Russian history and culture.

Pillar #2: Rapid job creation by the private sector.

The new parliament must encourage the rapid creation of jobs in the private sector. Otherwise, people laid off from the closure of inefficient state-run enterprises will not be able to find work. Entrepreneurs are employers. As former U.S. Housing and Urban Development Secretary Jack Kemp has observed, there cannot be more

4 Steve H. Hanke and Kurt Schuler, "Currency Boards for Eastern Europe," *Heritage Lecture* No. 355, June 20, 1991.

employees without more employers. Thus, to encourage the growth of private-sector jobs, the new Russian Parliament should pass legislation that:

- ✓ **Eliminates punitive rules and regulations that make it unprofitable for entrepreneurs to create new jobs and hire more workers.**

Government-imposed rules and regulations on private-sector business activity constitute a tax on entrepreneurship. The economic rule of thumb is: when something is taxed, there will be less of it. American workers, for instance, have lost at least three million new jobs over the past 20 years as a result of punitive rules and regulations, the financial cost of which is estimated to be between \$810 billion and \$1.7 trillion per year.⁵

Although no exact figures exist, the relative cost of similar rules and regulations in the Russian Federation must be very high. It is important, therefore, that the new Russian parliament act to eliminate all punitive rules and regulations that raise the cost of labor to employers.

Jobs Test. The new parliament should do more than simply eliminate old rules and regulations that stymie job creation in the private sector. It also should develop a mechanism whereby new rules and regulations are given a jobs test. Studies could be conducted to assess the impact of a proposed rule or regulation on the generation of jobs.

This would give the Russian people and their elected representatives a more accurate indication of the effects of a newly proposed rule or regulation. They could then make a more informed and reasoned judgment about whether it should become law.

The new parliament also needs to continue privatizing state housing and eliminate the system of police permits that hinder the mobility of labor. Many Russian towns and cities depend heavily on one antiquated factory or industry. If these are shut down as a result of privatization or the elimination of state subsidies, large-scale unemployment will occur. These workers must be permitted to move freely to seek employment elsewhere. Essential to this effort is the elimination of the police residence permits (*propiska*), which Russians moving to a new city must produce to prove that they have a job and a residence in that city. But obtaining housing and employment in a new city without having lived there for some time is very difficult. The permits effectively block the free movement of labor, which is critical in a stagnant economy such as Russia's. While the old Russian parliament passed a law lifting such restrictions, it has not been enforced in most parts of Russia.

Equally important is the development of a private-sector housing market. Indeed, only when workers have ready access to new housing throughout the county will they be able to move to more prosperous regions or cities. Essential to this effort is to continue the rapid privatization of housing, which would involve the sale of state housing

5 William G. Laffer, III, "How Regulation is Destroying American Jobs," Heritage Foundation *Backgrounder* No. 926, February 16, 1993, p. 1.

to residents. The aim of such a program should not be to make money for the Russian government; rather it should be to jump-start a private-sector housing market.

For this reason, the Russian government should either give away state-owned houses or sell them to residents for only a nominal payment. This would create a class of home owners, which would lead to a private-sector housing market.

Housing privatization has begun in Moscow, St. Petersburg, and some other cities, but much remains to be done. One reason for the delay is that, typically, more than one family resides in a Russian home or apartment. Deciding who should be awarded ownership rights and responsibilities is a real problem. In such cases, the Russian government should solicit competitive bids and award ownership rights and responsibilities to the person or family submitting the highest bid. The important consideration is not who in the private sector actually owns the house or apartment, it is that the house or apartment be privatized and not state-owned.

✓ **Establish unemployment compensation and retraining programs for workers displaced by the privatization of state-run enterprises.**

As inefficient state-owned enterprises are shut down, many Russians will need unemployment insurance. The money previously used to finance a factory's operations, for example, should be used to provide displaced workers with unemployment compensation and retraining. The funds also could be used by entrepreneurs as capital to start up new and more profitable businesses. Such unemployment insurance will enable laid-off workers to survive until they find a new job elsewhere, and free them for service in more productive enterprises.

Parliament should provide unemployment compensation for only a limited duration. The time period should be generous enough to allow workers to adjust to their new economic reality and find new work, but sufficiently brief so as to minimize the inflationary effects of additional government spending and prevent workers from becoming dependent on state welfare.

Pillar #3: A free and open market.

So that they can create new products for the Russian people, entrepreneurs need access to finished goods and raw materials. Entrepreneurs also need access to consumer markets to sell their products. A free and open market, in which trade can be conducted without government coercion and regulation, is essential to both efforts. To create a free and open market, the new Russian parliament should enact legislation that:

✓ **Establishes a legal framework that secures and protects private property rights.**

Entrepreneurs need legal guarantees that their investments are secure and their contracts enforceable. Otherwise they will not invest their money in legal productive enterprises. Neither will they make the material improvements to their property that lead to economic growth and development. Moreover, without legal guarantees of contracts, businessmen will be more inclined to rely on organized criminals for enforcement and protection.

Private property rights are the cornerstone of a free and prosperous society. A legal basis for these rights can be found in the new Russian constitution, which grants protection to private land ownership and allows Russians the right to buy and sell land. For this abstract right to have meaning, however, it must have a legal basis in statutory law. Thus, the new Russian parliament should:

- ◆ **Establish commercial codes governing the sale of goods and services**, which would provide Russian entrepreneurs with the common “business language” necessary to conduct trade with foreign investors. Such codes allow for the establishment of joint ventures, partnerships, cooperatives, and other business associations;
- ◆ **Develop a system of tort law to protect owners from civil damages to their property**, and laws to protect intellectual property;
- ◆ **Provide for a titling system that establishes an entrepreneur’s claim to ownership rights and responsibilities**, enabling businessmen to lease and mortgage their assets for new business and wealth creation;
- ◆ **Devise a system of contract law that defines the various types of legally protected contract actions**. Russians would then have legal protection for their purchases and thus be protected from unfair and exploitative mafia business practices, such as a breach of a property purchase contract.
- ◆ **Eliminates special subsidies and credits to state and collective farms**.

Nowhere are private property rights more important than in the agricultural sector of the Russian economy. Prior to the Bolshevik takeover in 1917, Russia was a net exporter of grain. The rapid growth in Russian private-sector farming during the early part of this century was mainly responsible for the healthy state of Russian agriculture at that time. Similar growth is taking place today in Russia. However, government discrimination against private-sector farmers is hindering greater progress. State and collective farms, for example, continue to receive a wide array of special subsidies and credits, giving them a competitive advantage over the private sector.

Russian government discrimination against private-sector farmers must end. Russia needs more private-sector farmers, not fewer. Farmers should be allowed to organize themselves however they choose. When given the choice, the vast majority will choose to operate privately, which is more profitable than operating on a state or collective farm. But they will only make such a choice in a free and open market. Private farmers cannot be expected to operate profitably if their competitors receive state subsidies. For an agrarian free market to work properly, the costs and benefits of competing choices must be clear. Because of the government’s continued subsidization of state and collective farming, the choice is anything but clear because the state is essentially financing unprofitable and inefficient farms.

- ✓ **End tariffs and other foreign trade restrictions, including import subsidies, export quotas, and excessive export controls and licensing.**

The benefits of free trade to entrepreneurial growth are undeniable. Indeed, the free and opening trading system established worldwide by the General Agreement on Tariffs and Trade (GATT) has been a catalyst for economic growth, resulting in a 500

percent increase in world trade since 1950. Global economic output during that same time has grown more than 220 percent.⁶

GATT members agreed to even more tariff reductions—on the order of 50 percent—in December 1993. The Organization for Economic Cooperation and Development (OECD) estimates that, when combined with more liberalized import quotas, such reductions will increase world income by \$270 billion over the next six years.⁷ Global economic output is expected to grow even more spectacularly, by some \$30 trillion over the course of the next decade.⁸

The lessons of history are clear: Trade liberalization means economic growth and development. The Russian parliament must heed this lesson and eliminate tariffs and other trade restrictions—including import subsidies, export quotas, and unnecessary export controls and licensing—that isolate Russia from the rest of the world. Entry into the GATT should be next on President Yeltsin's agenda.

✓ **Continues privatization of state industry.**

Entrepreneurs need access to finished goods and raw materials. These are difficult to obtain when the government controls the overwhelming majority of a country's scarce economic resources. This is, of course, the case in Russia. To correct this problem, the Russian parliament must privatize state industry as quickly as possible; because the sooner state assets are returned to the private sector, the sooner the Russian economy will grow and prosper.

The Yeltsin government's mass privatization program is essential to this effort and should be endorsed by the Russian parliament. With more than 80,000 state enterprises already privatized and several hundred voucher auctions taking place each month, Russian mass privatization is a truly impressive and historic achievement.

However, despite this progress, there is still much to be done. To speed privatization, the Russian parliament should:

- ◆ **Enact a bankruptcy law that will facilitate the liquidation of enterprise assets in the event of a bankruptcy.**

Most inefficient state enterprises are destined for bankruptcy. This is beneficial since it will free resources for new, more productive and useful private-sector production. For this to happen, however, Russia needs a tough and effective bankruptcy law, which it does not yet have.

- ◆ **Divest state enterprises of social service responsibilities, which are unrelated to their central market function.**

Many of Russia's largest state enterprises are responsible for a diverse array of social services such as housing, schooling, and day care. Such services are costly to the

6 "Nothing to lose but its chains. The ITO that never was," *The Economist*, September 22, 1990, p. 7.

7 Peter Passell, "How Free Trade Prompts Growth: A Primer," *The New York Times*, December 15, 1993, p. A1.

8 *Ibid.*

enterprise and a diversion from its central market function. They also discourage investors unwilling to assume responsibility for such social services. The new Russian parliament, therefore, should place responsibility for social services on local governments and volunteer agencies and permit business entities to perform their profitable, market-oriented functions.

◆ **Develop legislation that will sort out ownership rights and responsibilities for shareholders.**

Several thousand large enterprises already have been privatized, and outside investors possess millions of shares of company stock. What is needed now is legislation that will ensure effective corporate governance of these newly privatized companies. The rights of managers versus shareholders and outside investors versus workers must be clearly articulated and established in law. Otherwise, newly privatized enterprises will be rendered ungovernable and likely revert to some form of state control.

Moreover, the new parliament must stop subsidizing newly privatized enterprises. Survival of an enterprise should not hinge on special favors and protection from government, but rather on its ability to respond successfully to market forces. Indeed, in the absence of a cut-off of government subsidies and credits, privatization exists in name only and does little good. If a company owner or manager is to be given certain rights, he must also accept certain responsibilities, chief among which is responsibility for his own success or failure.

Pillar #4: Growing and dynamic capital markets.

Capital markets provide entrepreneurs with the means to increase the size of their investments. The Russian voucher privatization program, in which shares of company stock are purchased and traded, has facilitated the development of these crucial markets. It has created a stock or capital market through which people trade and invest in newly privatized companies. Those who make successful investments reap a capital windfall, which they can use either for additional investments or business expansion.

In Chile and Mexico, large-scale privatization programs have produced large capital markets. In Chile, for example, privatization has precipitated a huge increase in the volume of stock trade, which increased from \$41.9 million in 1984 to \$654 million in 1989.⁹ And the Mexican stock exchange has risen by more than 400 percent since 1987, to a current capitalization of nearly \$90 billion, largely as a result of the Mexican government's successful privatization program.¹⁰

The great and frequent fluctuation in the value of privatization vouchers in Russia over the past year demonstrates that capital markets are beginning to emerge in Russia. However, they are still in their most primitive stage of development. In part this is

9 William D. Eggers, "Yellow Light for Eastern Europe: Beware Four Economic Development Myths," *Heritage Foundation Backgrounder* No. 796, November 13, 1990, p. 7.

10 Lynn Scarlet and David Haarmeyer, eds. "Capital Markets," in *Privatization 1992: Sixth Annual Report on Privatization* (Los Angeles: Reason Foundation, 1992), p. 39.

because the Russian economic reform program is still in its early stages and capital markets take time to develop. To facilitate the development of capital markets in Russia, the parliament also should:

✓ **Permit foreign banks to operate freely in Russia.**

Because entrepreneurs need a safe haven for their money, private profit-making banks are needed. Very few privately owned banks exist in Russia today. This is because Russian banking during the communist era was dedicated not to the creation of wealth but to the subsidization of state industry. Few bankers in Russia are familiar with standard Western banking practices. Russian banks typically lose money and, given the high inflation rate, money deposited in these banks does not earn interest. Not surprisingly, many Russians choose to put their money elsewhere—in Western banks, for example.

The new Russian parliament can resolve Russia's banking problem by inviting Western banks to open up branches in Russia. These banks should be allowed to operate with only the minimum necessary government oversight. This would help keep capital in Russia, where it would be used to fuel economic growth and development of the Russian nation. It also would help create sound banking practices in Russia. Western banks doing business in Russia would hire and work with Russian firms or firms doing business with Russians.

✓ **Privatize the Russian banking sector.**

For the pool of capital available to entrepreneurs to grow, Russian-owned banks must become the backbone of Russia's financial system. Russia now has only five state-owned commercial banks and more than 1,500 non-state commercial banks, nearly all of which serve as conduits for subsidies to state industries. The state commercial banks receive loans from the Central Bank. These banks then must lend money to state enterprises at negative real interest rates—that is, at a rate less than the rate of inflation. Likewise, most of the non-state commercial banks are owned and governed by state industry.

There are thus few opportunities for Russian entrepreneurs to save money and develop a capital base for investment. For this to change, the Russian banking sector must be privatized and put on a commercial footing, attuned to the needs of the market and seeking to make money. Privately owned banks operating on a profit-and-loss basis will stop making bad loans to inefficient enterprises. Instead, they will loan money to private companies that should grow and create jobs for Russians. Once that happens, entrepreneurs will keep their money, savings, and other assets inside Russia, and not in foreign bank accounts.

✓ **Reduce taxes on working people so that they have more money to save and invest.**

Taxes on working people should be reduced so that Russians have more to save and invest. In other countries such as China and Japan, personal savings are an important source of capital investment. Chinese economic growth, for example, has been precipitated by a dramatic rise in peasant savings, which grew from an estimated 80 billion yuan in 1978 to more than 700 billion yuan in 1985.¹¹

The reason is simple: when the economy grows, there are more and better-paying job opportunities available to workers; and when people work more, they have more to save and invest. Additional savings and investment, in turn, provide entrepreneurs with a source of capital with which they can increase production. The result: more and better-paying job opportunities for workers and greater economic growth.

The Russian government needs to encourage Russians to work, save, and invest. It can and should do so by reducing taxes on working men and women, who now pay at least 40 percent of their income in taxes. Many Russians actually are required to pay much more, with upwards of 70 percent of their income going to the tax collector.

High taxes discourage people from working, saving, and investing, all of which are necessary for economic growth and prosperity. When they are too high, taxes force employees underground into the black market, where they escape taxation and inadvertently strengthen the hand of the Russian mafia. Reducing taxes on working men and women should be one of the new parliament's highest priorities.

CONCLUSION

Some people have concluded that the results of the December 1993 parliamentary elections, in which anti-reform parties from the far left and far right made significant gains, represent a repudiation of President Yeltsin's economic reforms. This conclusion is incorrect. Exit polls taken during the election clearly show that, notwithstanding the strong showing of Vladimir Zhirinovskiy and a number of anti-reformist parties, most Russians support more, not less, economic reform. Russia's difficulties indeed are not the result of too much reform pursued too fast; they are the result of too little reform pursued too slowly. "Shock therapy," or a rush to a free market economy, has not failed because it has not been tried. Consequently, for most Russians, too little has changed. And what has changed has been, in the eyes of most Russians, for the worse. Witness, for example, the growing power of the Russian mafia, now dominant in many Russian cities and towns.

Anti-reform nationalists like Zhirinovskiy exploited the understandable disenchantment of the Russian people for their own political purposes. But the Russian parliament has a greater purpose than serving as the stage for the political theater of Zhirinovskiy and his comrades. It must do something to improve the lives of Russians. This can be achieved only through new private-sector growth and development, which Zhirinovskiy and other anti-democrats and enemies of the free market cannot deliver. The only hope for economic prosperity in Russia is to enact a sweeping program of economic reforms as rapidly as possible.

A new reform program should rest on four essential conceptual pillars. They are : 1) encouraging entrepreneurship, 2) creating jobs in the private sector of the economy, 3) establishing a free and open market, and 4) setting up capital markets.

The challenges to establishing these four essential pillars are enormous. But never before in Russian history have the prospects for positive change been more within reach. For reform to succeed, the new Russian parliament must move quickly and act boldly, so that ordinary Russians can enjoy happier and more prosperous lives.

Russia is a great nation; the Russian people are a great people. Russia has produced some of the world's greatest artists, musicians and authors, scientists, and engineers. It

could be equally successful in the field of business and commerce, but only if its leaders and politicians allow it to succeed. Let the new Russian parliament take the first step.

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