

Russian Economic Reform
The Lessons for Transitional Economies
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Democracy is inherently imperfect; it is a mediocratizing process by which the necessary, but not sufficient, conditions of consensus and consent are achieved, resulting, at best, in a tentative governance.

Many Western politicians and economists are critical of Russia's reform efforts. I have a different opinion: I think Russia has made remarkable process. As noted above, democracy is a dynamic, "mediocratizing" process, but such "mediation" does not necessarily occur quickly, nor should it.

As an example, in 1986, I introduced several tax concepts to the United States Department of Treasury for inclusion in the tax code. Although introduced to a Republican administration, it was only ten years later, in a Democratic administration, that it became law.

Why should we expect Russia, wrestling with entirely new economic and legal concepts, to act precipitously? It is far better that the "politicos" get it approximately right at the outset (democracy, it can be argued, never gets anything exactly right....someone is always dissatisfied by the compromise). Moreover, in

Russia, by virtue of its political legacy, competing forces have little experience in the socio-dynamics of democratic compromise. The acquisition of such experience takes time.

In this article, we will discuss various aspects of the Russian economic transformation with the goal of providing insight into how other nations involved in radical transformation might learn from the Russian experience.

Moscow is not Russia.

The economic development of much of Russia lags far behind that of Moscow. While one cannot measure all of Russia by Moscow, one can certainly measure the potential of Russia by Moscow. In the almost 80 years of the Communist era, no new homes and no office buildings of Western standard were built in Russia. In the last six years, tens of thousands of new homes, apartments and office buildings have been constructed. This indicates the potential of the society when the freedom to act is not constricted by systematic political constraints. It is quite possible that the development Moscow could have progressed even further, were the preconditions for a market economy fully in place.

Yukos is Not Enron

Yukos is not Microsoft or Enron. The United States is dealing with problems arising from an extraordinary collapse of the so-called “high-tech” bubble economy that arose in the course of the 1990s and in the early part of the 21st century. Among the casualties were WorldCom, JD UniPhase, Time Warner America OnLine and Enron. Taken together, these companies have resulted in shareholder losses approaching half a trillion dollars. The government of the United States is now sorting out its legal approach to the problems arising from the collapse of the high-tech bubble, but it is an effort that is taking years.

It should not be surprising, therefore, that Russian prosecutors, having little or no experience whatsoever with economic crimes of the type typical in a market economy, are struggling with the issues arising from the Yukos affair.

At the time Russia began its transformation, which we might we take to be the last two months of 1991, with the selection of Dr. Yegor Gaidar as Minister of Finance and Economics and the 8 December 1991 meeting in Minsk, Belarus, in historical terms, extraordinary barriers to change had to be faced, perhaps even more extraordinary than might have been faced had there been a violent revolution.

Prelude:

There is much criticism of the Russian government with respect to its efforts at economic transformation and implementation of a “rule-of-law.” Fundamental to being a democrat is the obligation to distrust anyone holding power in a government and at all times. Therefore, the skepticism of the media is entirely proper, but it is also proper to add some perspective in view of the dynamic of events taking place in Russia.

One of the problems faced by commentators and journalists reporting on the Russian economy is a form of “tunnel vision.” That is, they tend to see what is happening in Russia in terms of its progress measured over the last 12 years. But is not really fair to compare the institutional status of Russia today with that of some standard, presumably applicable to western economies, which have evolved democratically over a period of several centuries. Moreover, few Western commentators and journalists really have an accurate perspective of the status of the Russian institutional structure at the time reform began.

To provide some background as to the status of the Russian economy at the time reforms began, the metaphor described below may be of some value. In a typical Western supermarket, the shelves contained over 10,000 items. At the time the Russian reforms really began, one might say in late 1991, and certainly in the pre-Gorbachev era, the array of Russian stores which provided for citizens ordinary daily needs of foodstuffs probably had no more than a total of 400 items on their shelves. If we scale this data, this would indicate that the status of the economy at the time reform's began was 0.4 on a scale of zero to 10. It might also be noted that, among these 400 items that were present on the shelves of stores, very few met Western standards of quality.

The almost incredible aspect of this metaphor, relative to the bases of a modern socio-economic free market, is that it can be applied across the entire institutional structure of the former Soviet system and in all the constituent states.

Forward

The motivation for this article came from the author's experience in providing legal assistance to the Russia or, initially, to former Soviet Union which, in the course of this assistance, became 15 separate states. In the end, most of the author's assistance was provided in the Russian Federation, particularly with respect to the

drafting of laws providing for regulation of the capital markets and advocacy of a simplified tax regime.

The creation of the Russian securities market was largely accomplished in the period from May of 1991 to the end of that year, specifically, when President Yeltsin signed decree No. 28 providing the legal framework for the startup of the Russian stock exchanges.

Things were happening very quickly at that time. The project to create a capital market was done with a working group consisting of about six lawyers from the United States and an equal number of lawyers from several of the Republic of the former Soviet Union.

In December of 1991, following Gorbachev's return from the South, after having being held in the attempted coup, President Yeltsin, in Minsk, Belarus, liquidated the old Soviet Union and set Russia on a path to the future as the Russian Federation.

It might very well have been better if all of the reforms with respect to the creation of a market economy had been able to be accomplished by Gorbachev within the context of the old Soviet Union. However, Gorbachev, and realistically, no one else, really knew what to do to reform the old Soviet Union. This was brought home to me in a conversation with Alexander Yakovlyev, a former member of Politburo who

was quite close to Gorbachev. In March 1992 Yakovlyev related to me that, upon his return to Moscow in August of 1991, in a meeting in his office the Friday after, Gorbachev was still contemplating how he could reform the Communist Party. Yakovleyv tried to explain to him that to the party could not be reformed. Indeed Gorbachev had no understanding of what was really needed to reform the old Soviet economy but then, nor did anyone else.

It is quite valuable to reflect upon the fact that, at that time, there were many scholars in the west known as “Sovietologists” that had a fairly comprehensive understanding of the structure of the old system, the people in the old system and how the politics of communism worked. It seems relatively apparent that no one anticipated the immediacy of the end of the Soviet system, nor what might be required for the process of transition to a new economic and political order. No one in the west really knew, in a well-defined way, all of the legal institutions that would be required to form a market economy when no such institutions had existed in the predecessor economy.

On the Russian side, the situation was even bleaker. Of the students who had studied economics and law, few, if any, really had any intuitive understanding of how a market economy works or had detailed knowledge of the legal institutions that would be required to support such a market economy. Making the situation even

more difficult was the fact that of even the best translators in “Soviet”/Russian society, and there were many very excellent translators, almost none had an intuitive understanding of the intricacies of a market economy in such a way that would enable them to facilitate translating the Western concepts into Russian. I would often find myself working with a translator, explaining the nature of a particular legal principle, listening to the translation, and realizing that the translator had really not understood at all the nuances of legal issue. Of course my own ability to translate into Russian was rather inadequate. However, my knowledge of Russian was sufficient that I knew when a translation was incorrect.

It is of great credit to the Russian people that, perhaps, 10,000 new words necessary to the functioning of a market economy have been introduced into the Russian language. It is remarkable that this has happened in less than a decade. Many of the new words, widely used in commercial practice around the world, have Latin or Greek roots as do many words in the rich Russian vocabulary.

The time Russia set off on its transformation to a market economy it faced problems of macro and micro scale.

The Macro-scale Problems: Policy Issues

First and foremost of the macro-scale problems was the fundamental issue of achieving a consensus as to which direction the society would move. At that time, it was not even certain that a move to a market-based economy would be the chosen

path. Indeed, even after six years of the Gorbachev era and two years of the Yeltsin reform era, as reflected in the 1993 constitutional referendum, less than 60% of the population endorsed the fundamental notions of private property. This is hardly an auspicious mandate for a rapid transition to a market economy.

There is much credit deserved to Mr. Gorbachev for recognizing the need for serious reform. An important lesson was learned in the Chernobyl incident, in that the Soviet government learned that it could discuss a disastrous event with the rest of the world without untoward results - indeed the world rewarded the disclosure with approbation rather than condemnation. Mr. Gorbachev was indeed well-intentioned but ill-equipped to provide the leadership that would have produced real reform in the ossified Soviet political establishment. Indeed, I believe very good argument can be made that, had Mr. Gorbachev been able to implement the needed reforms across the entire Soviet Union, it might have been much better for the entire region. This is not to blame Mr. Gorbachev, because he was raised in a system in which the training of lawyers actively discouraged legal scholars from learning the law of market economies and, indeed, as with economists who advocated market reforms in the sixties and seventies, legal scholars who might have similarly advocated the legal structures in support of market economies might well have been exiled.

That Mr. Gorbachev was not fully aware of the extent of transformation required by the old Soviet system is demonstrated by the fact that when he returned from his

sequestration in the South and mid August of 1991, within a few days he was meeting with his chief of staff And discussing the need for reform of the Communist Party, not realizing, as one of his colleagues on the Politburo noted to him in a meeting on the Friday following his return that the Communist Party was the problem and that it could not be reformed.

The second major problem that face the Soviet/Russian economy at its time of transition was inexperience in the dynamics of democratic politics. The fact is that there was almost no one on the Russian side that understood the integrated legal structure that was necessary to support a market economy. On the western side, with respect to proposals for technical assistance, there was also an extraordinary lack of understanding of the multifaceted, integrated legal framework which might be required to take a society from a “socialist” era to that of a market economy. The simple fact is that the Iron Curtain was quite effective as a barrier to normal or scholarly exchanges which might have provided young economists and legal scholars with the opportunity to learn the fundamentals of regulating market economies. Similarly, for Western economists and legal scholars, there was little opportunity to discuss with their Soviet/Russian counterparts as to what might be needed with respect to legal reform in order to transform the Soviet economy. Frankly, no one ever really expected that the opportunity for such transformation would be just over the horizon

A third problem was that, once it became clear that economic and legal reform might be a reality, there was an extraordinary mismatch of expectations. Indeed, one has to keep in mind the fact that there was no extraordinary mandate for reform and that President Yeltsin, having been a patriarch in the old system, though having no desire to look back, really did not have the knowledge as to what might be required in order to make real progress at transformation of the old Soviet system. Western governments held out the possibility of major infusions of capital in support of the reform effort, but in the post-Soviet administrative bureaucracies, this was taken to mean that real money would come into support the reformers. Indeed, except in the areas of Defense transformation, very little money actually was transferred to the incumbent bureaucracies. Indeed, a great deal money was invested in promoting economic and legal reform; however this was done by funding Western consultants to provide technical assistance to the incumbent bureaucrats.

A fourth problem faced by the incumbent régime in transforming the Russian economy was that the educational establishment was not prepared to provide the knowledge that was required by those that would be charged with the transformation of the legal and economic structures of the régime (the régime ancien). Indeed, in many cases, and quite understandably, there was real resistance in the educational establishment to the idea of economic transformation. Educators had been raised with notions of an economic structure that did not comport with economic reality but, nevertheless, had provided them with a comfortable living.

Having spent 20 to 30 years establishing themselves within the economic structure they had little desire to reinvent themselves. Moreover, educators, are generally entrepreneurial and tend not to see the opportunity to personally profit from the transformation, unlike many in the echelons of the political bureaucracy. Even to this day, many educators have not embraced reform. This crisis in education however has resulted in the opportunity for the many new educational institutions providing advanced levels of training in all academic disciplines.

A fifth problem encountered in the transformation was the resistance of the incumbent political bureaucracy to embrace economic reforms. As with the educational establishment, the political bureaucracy - employees of the many ministries and other agencies of government - had spent most of their lives establishing themselves at various levels of responsibility which, in a very real sense, they took to be their “property” interest in the society and they were not about to have that property interest arbitrarily taken from them. As with the educators, they had acquired valuable knowledge as to how to work within the old system and had almost no knowledge of what would be required to commensurate responsibilities in the framework of a market economy, and, at a relatively advanced age, few had the inclination to involve themselves in the acquisition of such knowledge.

A sixth problem was the financial condition of the Russian economy at the time the opportunity for transformation to a market economy arose. The peoples of the former Soviet Union and, in particular, the Russian people, lost tens of trillions of dollars in the communist era from 1917 until the mid-1990s. The Soviet economy produced no real cash flow in any measurable sense. Indeed, as will be argued below, it was mostly a “value - subtractive” economic system, in which the value of the final output of a productive process was less than the value of the inputs. Moreover, in November 1991, Russia undertook the obligation of the debts of all of the individual republics of the former Soviet Union and, at the same time, had to deal with both the economic and legal issues associated with the dissolution of a multinational economic and legal system.

Finally, there was an expectation that the transformation to democracy would be easy. After all, everyone craves freedom. However, democracy is dynamic compromise and the broad citizenry had no experience of compromise in the context of freedom of choice. As Churchill noted:

Many forms of Government have been tried, and will be tried in this world of sin and woe. No one pretends that democracy is perfect or all-wise. Indeed, it has been said that democracy is the worst form of government except all

those other forms that have been tried from time to time. Sir Winston Churchill, *Hansard, November 11, 1947*

The Micro-scale Problems: Economic Issues

The World Bank seized upon the dissolution of the former Soviet Union to radically expand its membership and became so caught up in the process of implementing institutional structures in the republics of the former Soviet Union that the legal and economic reforms necessary, certainly initially, were relegated to status as secondary considerations. Moreover, the absence of any fundamental legal institutions in support of a modern economy was so complete in the former Soviet Union that the modern-day bureaucrats and World Bank also had very little idea of how comprehensively to implement the economic and legal reforms that would be necessary.

As to the micro issues with which the Russian Federation was faced at the time of its undertaking of the transformation to a market economy, first and foremost, one of the major problems was the lack of monetary control by the Central Bank of Russia. Each of the former republics had the authority to print currency and did so with reckless abandon. This caused the several monetary crises in 1992 and 1993.

A second micro issue was the lack of a legal structure, particularly with respect to the debate about private rights of contract and the transfer of property from the old Soviet statist bureaucracy to private ownership. Moreover, no one ever had any experience with the transformation of such a large number of state-owned enterprises into private hands. As a result the voucher system was rushed and not as well thought through as it might have been. It was effective in transferring ownership to private hands. However, almost all of the Enterprises in the old Soviet system were value-subtractive enterprises. Therefore, the vouchers well reflected the underlying value of the Enterprises. As a result of vouchers had very little value in many of them were transformed for nominal sums. The fact is that the old state enterprises, as value subtractive, even with world-class management, were years away from any potential profits. Just as in western practice, when a corporation undergoes a Chapter 11 bankruptcy proceedings, it may emerge as a successful operating entity. This process however can take many years. At the time the privatization was taking place, there was no law on bankruptcy. In retrospect, it might have been much better to have provided with the voucher system “anti-alienation” provisions which would have prevented voucher owners from selling the vouchers for some period of time, perhaps, years, and also for the government to have retained a “look-back” mechanism. It’s quite likely that had such a “look-back” mechanism been incorporated into the privatization law, many of the issues with respect to the “oligarchs” might have been avoided and, indeed, the current litigation with Yukos might well have been entirely avoided.

A third issue was the legacy of “gigantomania” - that large enterprises ought to remain large. Indeed, there has been and is an effort to emulate the keiretsu (Japan) or “chaebol” (South Korea) models, notwithstanding the fact that these economic structures are imploding and that, in dynamic economies, small and medium enterprises are more efficient and provide far more growth in labor markets.

A fourth issue is the matter of capital formation. In the early 1990s, having come out of a period of almost 80 years of autarchy, the world of investment capital had very little interest in Russia. Moreover, as noted below, the banking system was absolutely unprepared for management of investment capital. There was no investment banking industry.

Individual saving in the old system had been relatively meager and there was very little incentive to save, as the primary determinants of a secure life in retirement, as meager as they may have been, had been provided by the old Soviet government.

Therefore, the idea that investment capital could be rapidly accrued by private savings was nothing more than an illusion. Moreover, the old economy had been one of primarily large-scale enterprises, badly managed as they may have been, but as entities, they were the natural targets for privatization and investment capital. Given the deficiencies of the voucher system noted above, it is not surprising that ownership very quickly became concentrated in the hands of those who became

known as the oligarchs. As old management had been highly inefficient and as most of the assets of existing enterprises were highly depreciated, is not surprising that a large-scale practice of asset-stripping was engaged in as a de facto substitute for bankruptcy, given that no bankruptcy regime existed.

A fifth major issue was the entire lack of a commercial banking system. The central bank under the old Soviet system was known as Sberbank. In the late 1980s and early 1990s, so-called “pocket-Banks” were formed with the investment of capital from their controlling enterprises. However, these banks were never intended to provide broad-based capital to small and medium-size enterprises and, as a result, only the larger enterprises received the lifeblood of investment capital. Much of the technical assistance which came into Russia in the early 1990s was also oriented towards large-scale enterprises, particular those in the natural resources industries, and as a result, most investment capital was placed in these industries.

Interestingly, although China receives a much larger total sum of foreign capital, ranging and amounts from \$40-\$60 billion per annum, on a per capita basis, the foreign capital coming into Russia is probably on a par with that being invested in China.

A sixth issue, also associated with capital investment, is termed the “rate of absorption” of capital investment. Individuals that had been raised in the old Soviet

system had little or no familiarity with highly sophisticated capital equipment and the educational system was not prepared to provide such training. The result was that foreign capital could only be absorbed at a measured rate.

A seventh issue is that of “capital flight.” The total amount of capital flight has been estimated to range from \$80 billion to a total of as much as \$200 billion. In my opinion, these estimates are high. One thing is certain, there is a significant amount of investment that takes place in the private economy within Russia that is never reported and therefore may be mistaken as capital flight.

An eighth factor that was of considerable import in the slow development of the Russian economy in the post-Soviet era was the barriers to entry into domestic and foreign commerce. There were no laws to support small and medium enterprises in the bureaucracy, and bureaucrats, protective of their own positions, had little or no interest in encouraging such business.

A ninth issue of crucial import in the transition was the absence of an effective judicial system. Of course, under the old system, decisions were essentially reached by party mandated judicial fiat. In the new era, following the dissolution of the Soviet Union, there was no legal structure in place, ergo, no laws for the judiciary to enforce and, moreover, no jurists were experienced in applying the normal commercial law so familiar to courts outside of the old Soviet Union.

Another important factor is that the academic training of jurists alone is not sufficient to ensure good judicial results, as there is a very important element of intuition that comes into play in litigation that can only be acquired by experience in a market economy.

In the paragraphs below an overview of the legal framework necessary to support a market economy will be discussed. Russia has made substantial progress at legal reform.

For nations which are seeking to follow the path to reform to freedom in the context of a market economy, from the Russian experience, and from that of other nations, is very clear that the essential element is sufficient political will. A market economy requires a very dispersed power structure. Monopoly, oligarchy, and autarchy are anathema to free-market systems.

Is almost impossible to install the legal framework for an effective market economy a dictatorial political system. The practical fact is that people in general and politicians in particular do not give up power easily. But indeed, the framework for a market economy is such that relinquishment of power is an absolute necessity.

Biographical Note -

Karl William Viehe has been the U.S. Vice Chairman of the Russian - American Securities Law working group (nee: SASLAW, Soviet - American Securities Law Working Group), Chaired by Mr. Richard Bernard, Executive Vice-president of the New York Stock Exchange. Mr. Viehe has been an Adjunct Professor of International Law at the George Washington University, Washington D.C., and Adjunct Professor of International Business at the American University, Washington, D.C. and a member of the faculty at the International Law Institute, Washington D.C. Mr. Viehe has twice been Co-chairman of the U.S. Department of Commerce annual conference on "Current Issues in International Trade" and three times co-chairman of the United States Internal Revenue Service's annual conference on "Current Issues in International Taxation."

In 1991-1994, Mr. Viehe served as legal consultant to Conoco Oil company with respect to its \$460 million investment in the Russian "Polar-Lights" oil project in northern Russia.

In 1996-1997, Mr. Viehe served as General Counsel for PromstroiBank of Russia with respect to its successful bid to become the first Russian bank to be accredited to open a representative office in United States.

In 1997-1998, Mr Viehe created the first "financial-instrument" guarantee to be issued by the World Bank's Multilateral Investment Guarantee Agency (MIGA) in the amount of \$100 million and successfully developed a strategy to obtain said guarantee for an international investment fund.

APPENDIX

The Legal Foundations of Market Economies

A) Constitutional Law

a) Constitution grants rights to the Federal Government, reserving all other rights to the individual states.

b) Bill of Rights - provides personal and collective freedoms

"Information is the currency of democracy. " - Jefferson

1) freedom of the press

2) freedom of speech

3) freedom of peaceful assembly

4) freedom of religion

c) Most commercial law is state law, not Federal law

B) Independent Judiciary

a) Most commercial disputes heard in state courts

b) Few commercial cases heard by the supreme Court of the United States

c) Appellate Review - in State and Federal Courts

C) Independence of Monetary Authority

a) role of the Department of the Treasury (Ministry of Finance)

b) role of the Federal Reserve Bank of the United States

D) Contract Law

a) Courts attempt to “find” a contract in a purported agreement between the parties

b) Courts attempt to enforce the agreement in accord with the best determination of the “intent” of the parties to the contract.

c) there is broad freedom to contract for any legal purpose

E) Law of Sales - Uniform Commercial Code

a) applies to commercial transactions among merchants

b) applies to transactions between merchant and consumer

c) provides common law and statutory warranties establishing legal rights and assurances to the parties in a commercial transaction

F) Law on Commercial Paper - Uniform Commercial Code

a) applies to transactions financed with “promissory” paper

b) applies to transactions paid by check

c) provides law regulating parties rights & responsibilities in the check “clearing process”....as to banks, individuals & assignees

d) emerging law on electronic transactions

G) Law on Secured Transactions - Uniform Commercial Code

a) securing legal rights in “tangible” personal property

b) securing rights in “intangible” property

G) Real Property Law - State Law

a) registration of real property ownership

b) permits “free” (without restriction, but not without cost) transfer of title

c) abuse of ownership & “adverse” possession

d) Hawaii Housing Authority v Midkiff -

Hawaii Housing Authority v Midkiff was a particularly interesting case for consideration in the context of Russian economic transformation. The great concern of a large part of the population is the legacy of the czarist era with respect to the abuse of property ownership. The case of Hawaii Housing Authority, a few large landowners owned most of the property in the State of Hawaii.

In the hundred years prior to the case, these land holdings had been leased to private individuals who had built homes upon the property but were ultimately in danger of losing their economic interest due to termination of leaseholds.

The Hawaii Legislature determined that within the public interest for the individual homeowners to be able to buy the property under their homes - at a market price determined by an arm’s-length process - and passed a law which compelled the sale.

The large property owners went through a lengthy appellate process which all mentally reached the United States Supreme Court. The Supreme Court upheld the Hawaii Legislature and the property was forced to be sold to the homeowners at fair market value. This case illustrates that ultimately the state retains the right to take property in the public interest but only if the property is valued by some arm’s-length fair market process.

H) Personal Property Law

a) registration of some types of personal property (cars, boats, planes)

b) permits “free” (without restriction, but not without cost) transfer of title pursuant to a sale or gift.

I) Intellectual Property Law

- a) patent law
- b) copyright law
- c) law of trademarks & servicemarks
- d) law of trade secrets

J) Tax Law

- a) sales, income & property taxes - State Law
- b) Federal Income Tax - taxed on a worldwide, not territorial basis
- c) Federal estate & gift taxes
- d) “national treatment”

K) Anti-Trust Law

- a) applies to monopolies, oligopolies & other concentrations of wealth
- b) legal action only available to the Federal government - no private remedies

L) Interstate Commerce Law

- a) should be no barriers to sale of goods among the states
- b) reasonable restrictions for health & well-being of state’s citizens permitted.

M) Interstate Transportation Issues

- a) should be no barriers to sale of goods among the states
- b) reasonable restrictions for health & well-being of state’s citizens permitted.

- c) truck & auto transportation**
- d) air transport**
- e) railroad transportation**
- f) interstate maritime transport (rivers, lakes & seaports)**

N) International Trade Law

- a) tariff barriers**
- b) non-tariff barriers**
- c) maritime issues (transport & trade at sea)**
- d) agricultural issues**

O) Banking Law

- a) licensing of banks & other financial institutions**
- b) capital adequacy**
- c) deposit insurance**
- d) auditing & oversight of operations (compliance officers)**

P) Securities Law

- a) oversight of the accounting industry**
- b) oversight of the stock exchanges**
- c) creation of a level “playing field”**
- d) regulation FD (fair disclosure)**

e) insider trading

Q) Bankruptcy Law

a) Chapter VII, “complete liquidation”

b) Chapter XI, reorganization & continuing operations

c) Chapter XIII (personal bankruptcy, restructuring for individuals)