ENTRY AND ENTREPRENEURSHIP: THE CASE OF POST-COMMUNIST RUSSIA*

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1. Introduction

Entrepreneurial effectiveness is measured by the movement of economic actors – their alertness to opportunities for mutual gain, and their sense of when and where to enter and exit a market. Consumers send signals to entrepreneurs, signaling when it is demanded that they enter or exit the market. Markets are measured by both quantitative and qualitative parameters. The size of the market matters, but so does the ability of the market to work, that is, to send clear signals to participants. Our purpose is to examine the Russian market's quantity and quality of entrepreneurial activity. How many producers and consumers are getting together is one part of the puzzle. The larger part of our story is how well they are able to make deals.

The Russian economic system has been a state of continual turmoil and reform for over a century, making it difficult for business to develop as the political, legal, and economic foundation continually shifts. The beginning of the 20th century saw Russia struggling to change its economic system from feudalism to mercantilism under the Czars. World War I ended with Russia in the midst of transforming its economic and political system into the world's first full-fledged communist system. The first months after the October Revolution were characterized by decree after decree detailing the aspirations of the Bolshevik leaders to usher in a new communist order. These decrees ranged from abolition of the exploitation of men and women to the nationalization of all industry. The period of communist optimism quickly gave way to the reality of perverse incentives and the inability of actors to engage in rational economic calculation.[1]

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[1] See Boettke-1990a and Boettke-1990b.

Lenin's introduction of the New Economic Policy (NEP) during the Spring of 1921, which attempted to reintroduce markets in order to save the Russian economy and the Bolshevik hold on political power is arguably the first of many Soviet and post-Soviet reforms intended to empower entrepreneurs to ignite economic growth. While the market mechanism resurfaced under NEP, it is important to remember that while 92% of all nationalized firms were returned to private hands, over 85% of workers were retained in the nationalized firms (just 8% of Soviet firms used 85% of the nation's labor).[2] Real economic decision-making remained in the state sector rather than in the private sector. This split between the *de facto* economic situation and the *de jure* economic plans persisted throughout the entire 20th century.

There are many parallels between the NEP period and today. The Nepmen (capitalist entrepreneurs during the NEP) lived in fear of reprisals against their wealth, much like current-day "oligarchs." Like today's typical Russian businessmen, the Nepmen's time horizon of investment was short, and many sought to hide their wealth or consume their assets in the short- term rather than expose those assets to confiscation in the near future.[3] The ambiguity of the economic environment under NEP was compounded by the struggle within the Soviet state in the wake of Lenin's incapacitating illness and subsequent death, whereas 1990's Russian markets fluctuated along with Yeltsin's increasingly apparent health problems. The turbulent end of Lenin's rule resulted in Stalin, as Yeltsin's turbulent end has resulted in Putin. The subsequent reversal of NEP in 1928 lead to the new round of centralization efforts, as Putin is also centralizing power by reorganizing administrative districts into seven super regions. Nonetheless, we do not yet know which way Putin's plans will lead. There is the Putin who chooses liberal (in the economic sense) Illarionov as an economic advisor, but this is the same leader who chose to visit a military industrial town (Snezhinsk) the first day after his election and proclaimed his insistence on increasing state support for the defense industry.[4]

The Soviet system found itself in a constant state of economic reform, as has the Russian Federation since December 1991. Regionalism, bonus systems, limited use of prices, and other hopeful reforms were all introduced at one time or another, only to be abandoned shortly after introduction. Arguably the most ambitious Soviet reform period was initiated under Gorbachev's *perestroika.* The official rhetoric of this period was bold, however, it failed to save the Soviet economy from further deterioration and instead hastened the death of the system. If the goals of *perestroika* were the maintenance of the Soviet system and improvement of the economy, the policies chosen must be judged to have failed.[5] Discerning what goals "reformers" of the Yeltsin era set is almost as complicated as determining what the results are.

[2] See Boettke-1993, p. 28.

[3] See Boettke-1993, pp. 88-105 and Boettke-2001, pp. 154-175.

[4] A comprehensive listing of Putin's schedule and speeches is found at his website, http://president.kremlin.ru/events/. Putin (2000).

[5] See Boettke-1993.

The collapse of the Soviet system in 1991 was supposed to usher in an age of radical transformation of the Russian economy towards a free market economy, governed by private property rights and incentives for entrepreneurs to enter the market. Yeltsin promised a new age of freedom and the possibility of prosperity for the Russian people. The Russian economy was no longer supposed to be a centrally administered economy dominated by state control of production, instead it was to move towards an entrepreneurial market economy, open to the entrepreneurial spirit and initiative of its people, who would trade with Europe and the rest of the world. However, the promises of 1992 soon gave way to continued state control, declining production (not necessarily a bad thing), declining productivity (a definite negative sign), and a surprising increase in overt corruption and crime syndicates. Logically, the reforms legitimizing profit should have brought the second economy into legal market, but instead the laws were still so discouraging to above ground commerce that the black market expanded. This odd result begs the question of how the promises of post-communism have given way to the ugly realities of today's Russia.[6] Our focus is on the economic front, in particular the inability of the post-Soviet environment to cultivate an entrepreneurial culture that allows individuals to realize mutually beneficial opportunities legally and in a depersonalized fashion. "[T]hink of going with a man you've never seen before, who may be trash or devil knows what."[7] Here a peasant is trying to decipher Chichikov's intentions, Gogol's leading man who is trying to buy "dead souls." The seller is as wary of Chichikov as some modern Russian sellers are of living consumers. Foreign or domestic, the stranger is not trusted readily. Since one result of the move from a simple to an advanced market economy is to diminish the need for face-to-face relationships for a mutually beneficial trade to take place, by this measure Russia is not yet an advanced market economy. Trading and exchange are omnipresent, but constrained by the political/legal/social environment which does not provide the needed background to the anonymous interactions that take place within an advanced market economy. Relational capital, in other words, remains the backbone of economic activity in the post-Soviet society, not the freedom of contract and the enforceability of those contracts by an independent judiciary. Face-to-face relationships matter as much in modern Russia as they did under the 19th century serf system or during the Soviet era. During Soviet times, the value of one's connections was labeled "blat," which was the amount of "pull" an individual had with suppliers, government clerks, or any other actor where relational capital is the currency.[8] Under Douglass North's definition of institutions, market

[6] See Boettke-2001, pp. 213-223.

[7] Gogol-1996, p. 50. This is a poem in prose, which uses some absurdist methods to describe the psychological and economic life of Russian under serfdom. This work in among the canon of 19th century literature, which is still widely read in Russia. Another telling quote for our purposes from Gogol's story is, "[T]he business indeed seemed profitable, yet it was much too novel and unprecedented." (p. 50)

[8] The economic definitions for blat may be found in a variety of texts on the Soviet economy. See Hewett-1988, Leitzel-1995, and Gregory/Stuart-2000. A recent book length treatment of the subject is Ledeneva-1998. The dictionary translation of blat is: "protection, pull, a friend at court, by backstairs influence." Smirnitsky-1987, p. 51.

institutions evolve so that there is no need for a "mutual coincidence of wants" (instead we use monetary currency) or for an interpersonal relationship between the buyer and seller (instead the rule of law provides impartial contract enforcement levers).[9]

2. Theoretical Contribution

The main analytical lesson we can take from the 100 plus year debate within the economics literature on the efficiency of a socialist economy is that socialism confronts four fundamental problems of social organization.[10] The four problems which all social systems of production must account for are:

(1) Property rights system and the structure of incentives;

(2) Prices and the ability to economize on information;

(3) Profit and loss accounting and the nature of economic calculation;

(4) Political organization and the interconnection between political power and economic performance.

The private property market economy is able to coordinate the production plans of some with the consumption demands of others in such a way that the mutual gains from exchange tend to be exploited by all parties. It is not that this economic order achieves perfect harmony of interests, but rather that the economic order continually adjusts to correct for errors by alerting economic actors to the gains to be realized by detecting and correcting those errors. Through a market, economic actors are led to engage in less erroneous behavior than previously. A vibrant market economy is one of continuous change, as economic actors adjust their behavior to accommodate the changing demands of others, and the changing circumstances within which they produce products so as to strive to minimize the costs of production. Without the institutions of private property, profit and loss accounting, and prices, economic actors will be without the incentives and information to guide them in this process of continual adjustment. Without the lure of pure profit, they will not be spurred on to discover new techniques of production, new products, or new ways to deliver traditional products to customers – all characteristics of a vibrant economic system.

In theory, the socialist system was to substitute collective ownership of the means of production for private property, and as a consequence achieve the rationalization of production by way of production for direct use rather than for exchange. Collective ownership proved to be non-operational in practice – control rights must rest with some decision-maker. Moreover, attempts to substitute

[9] North-1990. Relational capital is a concept developed in relation to the Russian economy in the groundbreaking work by Gaddy/Ickes-1998. For work on the broader importance of interpersonal relationships in the social and civic markets see Fukuyama-1995.

[10] For a history of the theoretical debate over socialism see Boettke-2000.

production for direct use for production for exchange turned out to be impossible for large-scale production and too cumbersome in small-scale situations. Without the means of private property in the means of production, the economic system will not be able to acheive advanced material production. The Marxist aspiration to leap from the Kingdom of Necessity to the Kingdom of Freedom simply cannot be realized by Marxist means.[11] The demonstration of the logical incoherence of the Marxist system belongs to the Austrian School of Economics, and in particular the works of Bohm-Bawerk, Mises and Hayek.[12]

Soviet history cannot be understood without these insights (the structure of incentives, the value of information, the necessity of economic calculation, etc.) being incorporated into the interpretive framework. The aspirations of Lenin, *et. al.* were confronted with the reality of the impossibility of achieving them by the Marxist means which inspired those aspirations in the first place. The Soviet system that evolved out of this failed experiment was more akin to the "*ancien regime*," rather than a source of progressivism in the modern world.[13] Mature Soviet socialism was in reality a system of attenuated property rights, not the abolition of property; of shortages and rents to those in position of privilege, not improvement in the social relations of production; of producer and consumer inefficiency, not rationalization of economic life; of political tyranny and repression, not a new era of democratic empowerment. The *de facto* organizing principles of the Soviet economic system diverged significantly from the *de jure* statements of those principles. This is an important point to stress because the economic manifestations of the Soviet system were a result of the *de facto* organizing principles, not the *de jure*. The *de jure* system was impossible to institute, but the unintended by-product of attempts to realize that the *de jure* system was a complicated *de facto* system, with its own social relations of production and its own tacit governing rules of human behavior. It is the *de facto* system that is being transformed, and not the *de jure* system that was supposedly in operation.[14] Now, the Russian *de jure* reforms have lead to *de facto* change, but that change did not merge the *de facto* and *de jure*. Sadly

[11] On the Marxian aspirations of the Bolshevik Revolution see Walicki-1995 and Malia-1994. On the impossibility of the realization of these aspirations through Marxist means see Boettke-1990a et Boettke-1990b and the references cited therein.

[12] Bohm-Bawerk (Bohm-Bawerk-1883) demonstrated the logical fallacies of the Marxian system with regard to value theory and distribution theory, and Hayek (Hayek-1944) dealt with the economic and political difficulties of central planning. Mises, however, is the scholar who dealt the most damaging criticism of the Marxian and socialist project in general. For a comprehensive critique of socialist proposals see Mises (Mises-1920 and Mises-1922).

[13] On the parallels between the domestic mercantilist system in France and the Soviet system see Anderson/Boettke-1997.

[14] The *de facto* organizing principles of the Soviet economy were traditionally under-examined. The economics of Sovietology tended to either be focused on models of optimal planning or an empirical examination of growth rates. Both research programs tended to mask the underlying economic forces at work. The black market, for example, was often noted in the literature, but not examined in any detail. This was certainly understandable given the data problems such a study confronts. But turning an eye away from this aspect of the Soviet economic system meant ignoring the dual reality of Soviet economic life. In the modern literature Ed Hewett (Heweet-1988) started the correction of this error in analysis. Also see Boettke-1993, Leitzel-1995, Levy-1990, and Shleifer/Vishny-1994.

enough, contrary to the goals of reform since 1991, the *de facto* and the *de jure* remain far apart. This is most evident in the continued persistent – in fact expansion – of black market activity in an age of market liberalization.

What we have learned from the analysis of socialism in theory and practice is just how fragile advanced material progress is with regard to the intricate institutional mix within which the economic game is played out.[15] Without the incentives produced by well-defined and enforced property rights, the information provided by freely fluctuating monetary prices, the discovery of opportunities for innovation provided by the lure of pure profit, and the learning signals provided by the penalty of loss, economic progress is retarded. In short, without the framework of the 4 P's – (1) secure private property, (2) freely adjusting prices, (3) accurate profit and loss accounting, and (4) a non-discretionary political order characterized by the rule of law – the three I's of (1) incentives, (2) information and (3) innovation will be absent (or severely truncated) from the social system of production. When incentives are aligned, and there is a continuous flow of high-quality information, economic actors will be guided to adjust their behavior to realize the mutually beneficial opportunities for exchange with others. It is in this context that the market mechanism can be understood as a learning device. Economic actors learn how to coordinate their activities with those of others within the division of labor. If they do not learn over time how to orient their actions to the actions of others within the social system of production, then the benefits of the division of labor will not be realized and the productive gains of the division of labor will have to be forgone.

The private property market economy provides the requisite incentives and information for economic actors to realize the benefits of social cooperation through the division of labor. In contrast, Soviet socialism generated a learning environment in which economic actors learned too little of what they had to in order to coordinate their behavior with others to realize mutually beneficial exchanges, and too much of the things which were not conducive to realizing the gains from exchange. In short, a market economy promotes positive sum games, while Soviet socialism promoted at best zero sum games, and most often negative sum games.[16]

Understood in this light, the reform task can be characterized as one of changing the learning environment within which economic actors interact to promote mutual discovery of the benefits from social cooperation. That is much easier said than done.[17] We are not going to tackle the broad issues of institutional

[15] Olson (Olson-1996) made this point with regard to economic development in general. Markets are not the answer, because elementary forms of markets can be seen throughout the world. It is the intricate mix of institutions within which the market is embedded that determines whether or not the social system of production is one which will promote material progress or hinder it.

[16] On the importance of moving from zero and negative sum games to positive sum games for human progress see Wright-1999.

[17] On the difficulties of changing the culture of learning see Boettke-2001, pp. 248-265.

and cultural transformation head on, but instead we are going to focus on one aspect of changing the learning environment in post-communist Russia – that is, opening the economy up to new entry by entrepreneurs who are alert to, discover, and act upon the opportunities for mutually gain that are currently unrecognized, and thus enable us to realize those gains by gaining themselves. If what is needed is a change in the economic environment, then the agent of change (the entrepreneur), and the institutional constraints within which that agent operates, moves to the center of the analysis.

3. Entry and Entrepreneurship

Much has been made of privatization during the post-Soviet era, and rightly so.[18] The task of privatizing the post-Soviet economy was an enormous undertaking. But most of the discussion of privatization has focused on the restructuring of existing state-owned enterprises, as opposed to the creation of new firms. It is our argument that this emphasis in the policy discussion has been imbalanced and that new entry should be seen as a primary indicator of changing learning environment.

A vibrant economy is an entrepreneurial economy. Entrepreneurship is vital to the economic system for at least two reasons: (1) entrepreneurship, in its arbitrage function, ensures that economic actors will continually adjust their behavior to realize the mutually beneficial gains from exchange, and move the economic system to the Pareto frontier on the production possibilities frontier; and (2) entrepreneurship, in its creative destruction function, ensures that not only will all least cost technologies be deployed in existing production processes, but there will be constant pressure to discover new technologies and new products to satisfy the diverse demands of consumers and thus continually push out the Pareto frontier.[19]

Entrepreneurial action, of both type 1 and type 2, possesses many characteristics. Entrepreneurship calls upon the human capacity to perceive and be alert to opportunities that currently exist, but are hitherto unrecognized. It also calls upon the human ability to imagine the future in a manner which others fail to see. In recognizing the previously unrecognized, and imagining the previously unimaginable, the entrepreneur engages in an act of dissent against the prevailing opinion. It is in essence a bold bet on an idea. An entrepreneurial society is one which encourages individuals to bet on their ideas and provides the institutions of finance to bring those bets to life.

It is important to recognize that entrepreneurship in terms of being alert to opportunities for private gain is universal and omnipresent and as such cannot

[18] See Boyko/Shleifer/Vishny-1995. Also see Blasi/Kroumova/Kruse-1997.

[19] See Kirzner (Kirzner-1999) for a discussion of this two-fold aspect of entrepreneurship.

be the explanation for why some societies are more prosperous than others. Instead of looking at *the act* of entrepreneurship, we propose that the focus should be on *the institutional environment* that enables entrepreneurial action of the arbitrage and innovative type. To tie this discussion back to the four P's and the three I's we introduced earlier, individuals will respond to the incentives of any given situation, and each situation an individual confronts will provide them with a flow of information about the environment they are acting within. But not all given situations are conducive to the sort of learning economic agents require to constantly adapt to changing conditions and accommodate the demands of their fellow players in the arena of economic life. Incentives and information are a by-product of the institutional environment within which economic actors interact, and they come in as wide a variety as the number of social/cultural and political/legal institutions that can be experienced. However, only a subset of these institutional packages enable agents to realize the mutual gains from exchange in a systematic manner, and thus, expand the wealth of a society.

Russia does not lack an entrepreneurial spirit among its people, instead it lacks the institutional framework for the natural entrepreneurial proclivities of its people to be channeled in a certain direction to realize existing opportunities for mutual benefit and continually discover new legal and depersonalized opportunities for mutual benefit. Russian entrepreneurship is not eliminated, but it is hindered and redirected in superfluous directions.

This is why we focus on conditions of entry. As long as individuals are free to entry into existing industries and start up new business ventures, they will continually sort out the genuine discoveries from the superfluous ones. As we stated earlier, it is the error detection and correction function of the private property market economy, and not its abstract ideal efficiency, that warrants praise. Yes, the market mechanism tends to produce more efficient outcomes, but this is a by-product of its operation and the process which brings it about is to be found in the detection and correction of error. The market mechanism is efficient mainly in the adaptive sense of the term, rather than in the static sense. What we mean by this is simply that the operation of the market, within a framework of well-defined and enforced private property rights, will provide incentives and information to economic actors to continually adapt their behavior to coordinate with the actions of others so as to realize the benefits of exchange. At any given snapshot in time, opportunities are going unrealized and thus inefficiency is evident. But as long as individuals are free to enter and reap the rewards of their discovery, today's unrealized opportunities will be tomorrow's realized profits.

4. Entry In Post-Communist Russia

Policy makers in Russia have been reconstructing the economic system since 1992. Rhetorically, this reconstruction was guided by the objective to instill the market mechanism so that Russia may become a prosperous competitor in the global economy. A series of half-measures and ill-conceived policies instead exacerbated inherited economic problems and put Russia through an economic downturn worse in officially recorded statistics than the Great Depression. Just as Yevgeny Yevtushenko tells of the "fatal half measures" taken throughout the Soviet period, today's problems echo past Russian reformers' mistake in administering only half the medicine to half of the system and then wondering why the whole system remains off-track.[20]

The industrial production system prior to the fall of the Soviet Union was a state-sponsored monopoly, where all entry and exit into the market was dictated by considerations other than consumer demand. Instead, the planners' preferences, and their estimations of the needs and capacity of the economy dictated all legal entry and exit of production.[21] Soviet statistics reported that in 1990, 80% of the volume of output in the machine-building industry was manufactured by monopolists, and that 77% of machine-building enterprises were monopoly producers of particular commodities. Locomotive cranes, tram rails, sewing machines, coking equipment, hoists for coal mines, and sucker-rod pumps were produced by pure monopolists within the Soviet economy. About 2,000 enterprises were sole producers of specific products throughout the Soviet Union.[22] In the Soviet context, discussions of market share or even natural monopoly are not the issue, the monopolistic character of the industrial economy was a result of a conscious and active effort by the government. Additionally, many of the monopoly producers were often encouraged to vertically integrate as much as possible, which has led to many problems for post-soviet enterprises.

5. Privatization

Privatization was conceived as a form of demonopolization and depolitization policy. As Boycko, Shleifer and Vishny state: "The goal of privatization was to sever the link between enterprise managers and politicians ... so as to force firms to cater to consumers and shareholders rather than politicians."[23] They claim that depolitization was the most important objective of the privatization policy, and that the strategy chosen was intended to concentrate control and cash flow rights in the hands of enterprise managers and outside investors in order to speed the transition and minimize opposition.[24] On the other hand, the European Bank for Reconstruction and Development claims that the purpose of privatization programs was to stimulate economic growth by enhancing the performance of former state firms.[25]

[20] Yevgeny Yevtyushenko's *Fatal Half Measures*, is a collection of his writings where he tries to affect the government's interaction with the public. Bouis ed. (Yevtyushenko-1990).

[21] Bottom up, the second economy emerged and augmented the planner's preferences by responding to market demands as only people on the ground are able to. Local entrepreneurs exercised economic insights that planners far away in Moscow were unable to discern. See Grossman-1985.

[22] See Kroll-1991 pp. 144-45.

[23] Boyko/Shleifer/Vishny-1995, p. 11.

[24] *Ibid.*, p. 69.

[25] EBRD-1998.

The fact that the above goals diverge has a variety of implications. Most notably, both parties, each with different goals for the privatization process, were part of the same team of advisors. If they could not reconcile the goals of the reforms, then how were those living with the outcomes of the reforms suppose to? One approach to privatization focuses on depolitization and creating conditions for entry, the other focuses on improvement in the efficiency of the pre-existing industrial structure through improving incentives and accountability. By either measure, neither goal has been completely achieved. For example, Governor Konstantin Titov of Samara Oblast told the State Duma (the lower house of the Russian parliament) that government ought to support monopolistic behavior by Russian enterprises internationally and regulate their operations in the domestic market. These are the words of a supporter of the enterprises, who also urged the Duma to "stop attacks" on Russia's big business and not to make pariahs out of businessmen. It is dispiriting, but these are some of the most pro-market words to be spoken by any Russian elected official.[26] Nonetheless, during the mid 1990's, economic victory was widely declared by scholars, Western advisors, Russian government officials, and the press on both sides of the Atlantic. However, some scholars, journalists, and economic crises showed that Russia remained far removed from being a market economy.[27]

One major issue of concern to some scholars on privatization is the issue of corporate governance.[28] There is little doubt that the evolution of a corporate governance system is an essential component in the discipline of the market which compels economic actors to discover betters ways to arrange their production plans so as to satisfy consumer demands. However, corporate governance is a resultant of the market process, not a cause. Imposing effective rules of corporate governance on the pre-existing firms is a backward looking approach to reform. As Boycko, Shleifer and Vishny put it: "controlling managers is not nearly as important as controlling politicians, since managers' interests are generally much closer to economic efficiency than those of politicians. Once depolitization is accomplished, the secondary goal of establishing corporate governance can be addressed."[29]

It is our contention that there has been too much emphasis placed on fixing the past, rather than concern with the future. There are high costs associated with restructuring an existing system, which might outweigh the benefits, especially when we focus on a particular industry.[30] The primary benefit of privatization in Russia was not efficiency gains, but the basic redefinition of the relationship between the economy and polity. Transformation requires credible commitments

[26] Panshina-2000.

[27] There were some cheerleaders declaring Russia's transition to a market complete, including; Aslund-1995, Layard/Parker/Layard-1996. There was also a variety of articles in the *Financial Times* (John Thornhill), *New York Times* (Michael Gordon), and the *Washington Post* (David Hoffman), telling of how well the Russian economic transition progressed. They of course also wrote Cassandra stories as well, but often closely followed by a new cheerful story. Some skeptics of declaring an early victory before the August 1998 devaluation were: Gaddy/Ickes-1998, Ericson-1998.

[28] Frydman/Rapaczynski-1994, pp. 46-74.

[29] Boyko/Shleifer/Vishny-1995, p. 65.

[30] See Tollison and Wagner (Tollison/Wagner-1991) for a discussion of the political economy of demonopolization.

to limit the influence of the polity on future economic decisions. Looking at matters from this perspective, privatization is no longer seen as either a vehicle for efficient industrial restructuring or social justice. Instead, it is part of a package seeking to establish a credible commitment to a new political-economic order.

One implication of our argument for a realistic political economy model of industrial reform is that the emphasis on privatization and corporate restructuring (however formidable those changes are) is misguided and leads to misleading implications for reform. The social transformation required will not come from restructuring existing industry, but from creating conditions which lead to the introduction of new industries and competition from both below and abroad. Obviously, competitive entry will compel the pre-existing structure to transform, but the metamorphosis of the old system is not the goal, rather it is a by-product.

Entry of new competitors brings benefits beyond the improvements in organizational efficiency. Competition compels individuals and firms to employ the existing stock of technological information in the most efficient manner possible. New competition also prods economic actors to discover new technological knowledge which expands economic possibilities. Additionally, competition from abroad, in a situation where the previous regime was closed and highly regulated, imports not only improved technology and management practices, but a pricing structure determined by market forces, giving clear signals to entrepreneurs and consumers alike.

As competition challenges the old order, we expect that the old order will attempt to use whatever remains of its old political network to stave off the threat. The not-so-subtle difference between policies which protect competitive entry and those which protect against competition are usually wrapped in a policy rhetoric that is more subtle and difficult to decipher. This lack of clarity is both a strength of the policy and a main reason these policies are so hard to eradicate.

Looking at the empirical information on Russian privatization since 1992, we must keep in mind the differences between protection of conditions of competition and protection from competition. Our contention is that successful transition should be evidenced not by the transfer of former state-owned firms to private hand, but through the establishment of institutional conditions which foster new private firms to dominate the economic scene. The industrial reallocation necessary will not come from putting old wine in new bottles, but from the production of new wine. If most measured economic activity remains in either the state sector or in mixed ownership structures, then despite privatization activity we could be witnessing a process where the main organs of economic life remain outside of the entrepreneurial rivalry of transparent market competition. In sum, Russia has not become a market.[31]

Exaggerated rhetoric has been characteristic of Russia's privatization and other economic reforms since their beginning. This rhetoric planted great expectations and reaped great disappointments. This undermined the credibility of the "good

[31] We can divide the literature on Russia's reform efforts as either "believers" or "skeptics". The believers are represented by Aslund-1995, Layard/Parker/Layard-1996. The skeptics are represented by Gaddy/Ickes-1998, Leitzel-1995, and Ericson-1998.

word" of the government, which is easy to lose and difficult to restore. After the failed coup of August 1991, the path was cleared for Yeltsin to pursue a radical approach to economic reform, if he chose to push bravely ahead. Instead, Yeltsin wavered between reforms, Prime Ministers, and incursions into Chechnya. At the hopeful start, November 1991, Anatoly Chubais was named minister of privatization and chairman of the State Committee for the Management of State Property. Throughout 1992, a debate over the strategies and goals of privatization took place. Reformers set a target figure for privatization at 70% of the economy. In the Summer of 1992, Yeltsin chose to wrap the privatization campaign in the rhetoric of "people's capitalism," and with that the voucher privatization program was introduced in Russia. The basic idea was to distribute to each citizen a privatization voucher worth a nominal value of 10,000 rubles. As of October 1992, Russian citizens could pick up their voucher for a fee of 20 rubles. Once in hand, citizens could do one of three things: (1) sit on the voucher until June 1994 [the original date was December 1993] at which time they would become void; (2) sell their vouchers to others at a market price [by February 1993 the price had fallen to 3,900 rubles, though the price did rebound to 10,000 by June 1993]; or (3) swap the voucher for shares in a joint stock company. In the wake of voucher distribution mutual investment funds emerged. In exchange for vouchers, citizens would receive shares in the mutual fund. The funds would take the vouchers obtained and purchase shares in newly privatized enterprises. Investors, on the other side of the exchange, were able to diversify their holdings. The idea caught on, and there was an explosion of mutual funds. The MMM scandal was one of the most notorious of the failures of this by product of voucher privatization, which promised unrealistic returns and was able to pay off to early investors by relying on flow of resources from new investors (in other words, a classic pyramid scheme). Despite the troubles, by March 1994 Chubais claimed that: "the promised crash has not occurred and it can no longer occur. More than half of our gross national product is already produced outside of the state sector."[32] This marked the start of a veritable flood of books and articles declaring market economic victory, which swiftly turned into cries of "who is to blame" and "who lost Russia" after the August 1998 devaluation.

What exactly privatization meant throughout the 1990's and what it will mean when it is "completed" is still unclear. One result was the proliferation of hybrid forms of enterprise, which are actually some mixed ownership type, and thus do not constitute complete privatization. The government still has a large hold on the national economy. As of 1998, the register of federal property contained information about 44,212 federally owned enterprises and institutions and joint-stock companies (partnerships) with federally owned stock (shares). This included 19,417 state enterprises, 19,392 state institutions, and 5,412 joint-stock companies in which the state has a share of what is called the "nominal capital." Due to holes remaining in the legal framework, the government admits to continued shortcomings in their accounting for federal property.[33]

[32] As quoted in Aslund-1995 pp. 265-266.
[33] Russian Federation Comptroller's Office-1998.

Nonetheless, by some opaque maneuvers of accounting, Russian and Western statistics list these hybrid enterprises as privatized. This is clearly distortionary. To the extent that hybrid forms come to dominate the political process it suggests that our conjecture concerning the political economy of restructuring possesses empirical content.[34] Another sign of how much of an impact that government has on business is the amount of time that businessmen invest in government relations. In October 2000, a group of entrepreneurs announced that they will transform into a political party, rather than remain strictly a business association.[35] Although privatization in theory created completely private, hybrid (part private and partially public ownership), and government owned enterprises, the Russian government continues to exert influence and pressure on all enterprises, albeit by differing methods. If being a private firm means working free of government exerting influence on production behavior, unfortunately we have yet to see completely private firms.

Admittedly, the privatization program in Russia brought some significant changes. The magnitude of the privatization efforts was large early on, decreased in the mid 1990's, and may possibly rise next year if Putin follows the current plan, which is to sell off 10,000 enterprises next year, with the majority of government revenues expected to comefrom only 20 of the 10,000 enterprises for sale. Of these 20 high valued enterprises, few are intended for complete privatization. The government will sell an additional 3.73% of Gazprom, but will continue to hold shares.[36] As energy prices have risen over the past few years, much of the Russian economic recovery from the August 1998 devaluation is credited to the rising revenues of its energy producers, primarily Gazprom. Now, while Russia's share of global trade has plummeted (in 1990 Russia made up 2.6% of global exports and 2.7% of global imports, 1999 it held 1.3% of world exports and 0.7% of the imports) the amount of raw materials the export has risen. Russia exports 20-80% of its raw materials output (sadly, this is as concrete a figure that may be found to summarize the sale of natural resources; oil, gas, diamonds, metals, etc.).[37] The amount of control the government exerts over Gazprom varies from region to region, from month to month, and has not shown to be anymore consistent than the government relations with any other enterprise. This is at the core of the problem – not only does the government interfere far too often, but it does it in an inconsistent manner. Firms are unable to plan on what amount of interference any forthcoming changes will bring, so they continue to invest in relations with government. Still, privatization has changed the form of a number of enterprises, if not their behavior.

Privatization's scale has varied as much as its goals. At its height in 1994, 22,000 companies were privatized, which dropped to 10,100 in 1995, and fell as low as 677 enterprises privatized in 1999. Sometimes privatization was touted as a

[34] On the role that hybrid ownership forms play in the transition economies see Pistor/Turkewitz-1996.
[35] Dorofeyev-2000.
[36] Feifer-2000.
[37] Panova/Rachkov-2000.

source of funds for the administration, while at other times the benefits to the economy were emphasized. Once again, the Russian government is sending mixed signals on its mixed economic plans. Officials laud 20 of the upcoming privatizations for the funds they will bring in, while the 10,080 others marked for 2001 are to be privatized solely in the name of economic efficiency.[38]

While the economic changes brought about through privatization are impressive in quantity, they do not imply anything about the magnitude of the qualitative change. We must be willing to look behind the numbers.[39] State and municipal enterprises are counted as privatized provided that there is a decision to transform the enterprise into a joint stock company, and that there is an approved plan for privatization. So the level of activity recorded may overestimate the actual amount of privatization. This is reflected in the numbers when we look at the allocation of enterprises by ownership type in the Russian economy. In 1999, 74 percent of all enterprises were in private hands (2,147,000 total), a respectable growth from the 62.5 percent of enterprises that were privately owned.[40]

Creation of a market economy implies freedom of entry and exit, and bankruptcy is taken as a proxy measure of the market's ability to discipline at the firm level decisions of economic actors through exit. The market *system* is a profit and loss system and thus economic actors must be able to reap the rewards of their economic bets, but also be responsible for the losses they may incur in decision-making.[41] Bankruptcies have not been completely embraced by the reformers during the transition, but their use has evolved continually throughout the 1990s.[42] Sometimes bankruptcies were carried through to clear out companies that had more liabilities than assets, which is rather a logical function for a bankruptcy. Recently, however, more and more companies are facing bankruptcy because they actually hold more valuable assets. So although they are in debt, they are liquidated before companies that are in worse condition so that those in charge of their liquidation may collect the bankrupted enterprise's assets. This practice has been called "de-privatization," whereby the government goes after firms it had privatized and seizes them for non-payments of tax liabilities. Given the complex and at times contradictory federal and municipal tax laws, any firms that display wealth are vulnerable to such a liquidation. For example, Norilsk Nickel, the largest nickel producer in the world, was under threat of bankruptcy in just this fashion.[43] Bankruptcy statistics are as confusing as those for privatizations, and must be

38 Semenenko-2000.

39 For problems with Russian and Soviet statistics see: Treml-1972. Feshbach-1994 and Grossman-1985.

40 Goskomstat Rossii-1999, p. 272.

41 For a general discussion of the necessity of failure in a vibrant economy see Lee/McKenzie-1993. In the real existing socialist context, the government protection against economic loss was referred to as the "soft budget constraint". On the perverse consequences of soft budget constraints see Kornai-1992, pp. 140ff.

42 See Moss (Moss-2000) for a discussion of the issue of bankruptcy and its implication for economic reform in Russia.

43 Latynina-2000.

treated with care. The number of bankruptcy cases filed have approximately doubled every year since 1995. During 1995, only 1,108 cases were filed, 2,600 were filed in 1996, and the number rose to 9,500 cases in 1999 and 7,000 cases between January-June 2000. However, of the cases filed, at most half decided to go through with complete liquidation. For example, only 4,562 of the 9,500 cases filed in 1999 were "launched." This means liquidation of the enterprises were started, but this does not imply anything about their completions.[44]

One of the latest complications introduced into bankruptcies is a proposed "blacklist" for those who "reduce enterprises to a state of bankruptcy." So, rather than have bankruptcy be a means of exit for an entrepreneur's mistaken calculations, it turns into a stigma that businessmen would avoid at all costs, constraining their entry and exit. Bankruptcy should be seen as something to be avoided, but this "blacklist" is worrisome because of how it increases government involvement in the market and gives incentives for market distortions to become entrenched. There is no need for the government to say who is a good or bad businessman, rather this task should be left to the market. This possible intrusion is due to the involvement of a reformer, German Gref, who usually drafts plans on how to get the government out of the economy.[45] Singling out Gref leads to the other problem with this government incursion into the market – its effect on solidifying the importance of relational capital between businessmen and government officials. An enterprise should be bankrupted based on its inability to manage its assets, not on the manager's inability to get along with the local mayor. Thus, looking at how economic advisors lead Putin to reign in market forces is as least as important as looking at any of their statements in support of the market. Like businessmen, as scholars we must make a cost-benefit analysis of the economic reforms and the reformers.

It is also useful to look at employment, volume of production (an output measure), and ownership to gain some perspective on the economic developments in Russia over the past few years. Looking at all of these factors together fosters many insights that looking at any of these figures in isolation lacks. Looking in particular at the industrial sector we find that looking at the type of ownership does not paint a clear picture of the sector. Ownership, percentage of labor, and the percent of the sector's total volume of production looked at together demonstrates that while government ownership is declining, it still controls a disproportionately large amount of industry through the workforce and volume of production. Although the government owned only 5.1 percent of industrial enterprises, it produced 11.4 percent of the industrial sector's output, using 15.6 percent of the industrial sector's labor. This is to say nothing of the "private" industrial enterprises which fulfill government contracts or receive inputs from government held enterprises.

[44] Panova-1997, Babayeva-1998, RIA-1998, and Prokopenko-2000.
[45] Khrennikov-2000.

Industrial Workforce, by Type of Enterprise Ownership

Years	**% of Industrial Workers, who Work at Enterprises which are,**	
	Privately Owned	**Government Owned (Federal and Municipal)**
1994	22.6	27.7
1995	27.3	17.8
1996	35	15.3
1997	32.7	13.7
1998	37.4	15.6

Source: Goskomstat Rossii, *Rossiyskiy Statisticheskiy Yezhgodnik; 1999.* (Moscow: Goskomstat Rossii, 1999) p. 308.

Industrial Production, by Type of Enterprise Ownership

Years	**% from the Total Volume of Industrial Production, which is,**	
	Privately Owned	**Government Owned (Federal and Municipal)**
1994	15	21.5
1995	18.9	11
1996	25.2	10.4
1997	25.8	10.2
1998	27	11.4

Source: Goskomstat Rossii, *Rossiyskiy Statisticheskiy Yezhgodnik; 1999.* (Moscow: Goskomstat Rossii, 1999) p. 308.

Industrial Enterprise Ownership

Years	% of (total number of) Industrial Enterprises that have,	
	Private Ownership	**Government Ownership (Federal and Municipal)**
1994	72.1	8.9
1995	72.3	7.7
1996	87.1	4.4
1997	88.1	4.4
1998	88.1	5.1

Source: Goskomstat Rossii, *Rossiyskiy Statisticheskiy Yezhgodnik; 1999.* (Moscow: Goskomstat Rossii, 1999) p. 308.

In 1994, it was estimated that 60% of the labor force was working primarily in the private sector. However, even this might underestimate the real situation because much private activities still tend to go unreported in order to evade taxation and registration. The government thinks that "shadow turnover" may account for 30% of all Russian trade.[46] Of course, it has difficulty accounting for firms that are trying to disguise their existence from the government. While Goskomstat (the Russian government's statistical agency) estimated that in 1993 there were already 700,000 small enterprises, accounting for 11.5% of all employment. From reported figures, 58% of Russian small enterprises are in trade, and 75% of retail trade is estimated to be accounted for by new private firms.[47] Certain sectors, such as retail, do reward more legal economic development than others, such as industry. The sectors that are more fertile for new entry are those where there is both a pent up consumer demand in combination with the lack Soviet enterprises leftovers, bringing along with them misleading signals. A sectoral *tabula rasa* may be the best open door for businessmen. This at least is likely to ensure that they face fewer barriers to entry.

[46] Panova/Rachkov-2000.

[47] See Aslund-1995, pp. 263-264.

A decade into the transition, and it remains difficult to report on the activity of new private enterprises. From reports we have both "unprecedented" privatization (90% of industrial output is said to have passed into private hands) yet state control remains in a large share of supposedly privatized firms. As Blasi, Kroumova, and Kruse report:

> The market is risky, it is unpleasant, it is not egalitarian; and it tempts the Russian state – whoever possesses the state power at the end of each election – to try to tame and control it in the interests of politicians. The fact is that the Russian state still owns more than 10 percent of about a third of all the already privatized corporations in the country and more than 20 percent of a quarter of them. On average, according to recent estimates, the state owns over a third interest in the top 50 corporations in the country and may own a modest interest in the next 250 large corporations, which may help determine who ultimately controls those companies. The state and existing owners or aspiring owners will struggle over what happens to this residual state interest – which does not include several thousand firms that were never privatized in areas as diverse as coal, precious metals, health and communication services. The partial or full state role in these firms suggests a continuation of subsidies, a drain on the state budget, and ongoing attempts to combine economic and political activity.[48]

The Yeltsin years witnessed a continuation of what was already prevalent under the Gorbachev regime, the continuation and expansion of unrecorded economic activity at a time when the policy regime was supposedly favorable toward the development and expansion of markets. Registration and taxation remain impediments to the development of new enterprise and the discovery of better ways to satisfy consumers. Ambiguous property rights and discretionary enforcement of contracts by the government officials have led to the rise of alternative contract enforcement mechanisms, some of which have high negative externalities (such as mafia killings and the like). Policies which hinder the above ground legitimate expression of entrepreneurial discovery must be eliminated for the further development of the Russian economy towards a market system and away from the current "virtual economy."[49] Institutions of governance must be established which reduce political uncertainty and encourage individuals to be willing to bet on their ideas and find the financing to bring those bets to life. Financial intermediation is a basic institution that needs a set playing field where smart bets are rewarded and bad gambles are punished.[50] As sure as the rain will bring out umbrella salesmen onto city street corners, the right incentives will bring entrepreneurs into the market.

48 Blasi/Kroumova/Kruse-1997, pp. 168-9.

49 Gaddy/Ickes-2001.

50 For more on the problems of financial market imperfections creating liquidity constraints see, Diamond-1984 and McKinnon-1973.

6. Conclusions

Maybe these yellow arrows slanting in through the window were conscious, hoped for something better- and realized that their hopes were groundless, giving them all the necessary ingredients for suffering.[51]

Pelevin's "yellow arrows" are sun beams, that do not choose where they fall. They may land in a forest where their energy may be put to use helping flora grow, or they may land in a barren city scape where their energy is dissipated. Russian entrepreneurs did not choose their setting, and they are forced to watch their entrepreneurial insights dissipate in a rent-seeking landscape. Like Pelevin's "yellow arrows," Russian businessmen are stuck dealing with the Russia they live in and the incentives that have emerged from the transition since December 1991. These are not the incentives that the Western or Russian reformers planned for, but the incentives that were created from the ground up by citizens dealing with the mixed messages from all the incarnations of Yeltsin (Chubais-Yeltsin, Chernomyrdin-Yeltsin, Nemstov-Yeltsin, etc.). Entrepreneurs will utilize any opportunity for profit, under a central economy or a market economy. The market economy allows entrepreneurs to profit from value creation, whereas a planned economy gives entrepreneurs incentives for rent-seeking. Under either system, the entrepreneur acts 'rationally', but what that means differs as the environment changes. Modern Russia is a market which gives the entrepreneurs mixed signals, with unfortunately more incentives left in value redistribution than in value creation. This hurts the country; entrepreneurs, consumers, pensioners, and all citizens whose welfare is tied to the national economy.

The political scientist Russell Hardin has argued that economic liberalism was a practice in search of a theory, while political liberalism was a theory in search of a practice.[52] The double transition in post-communist Russia is attempting to bring into coincidence these two liberal doctrines. But as Hardin's historical quip should remind us, while economic liberalism is not a result of constructivism, political liberalism might require a form of constructivism (a fact Buchanan has also stressed in opposition to Hayek). What is most important to emphasize is that the form of that construction of the polity is not benign with regard to the operational properties we can attribute to the spontaneous order of the market. Privatization policy is but one example of the transition process which highlights this tension – as models of privatization from above may actually impede the development of the private sector from below.

51 Pelevin-1994, p. 8. This author is widely heralded as the strongest literary voice of Russians living through the chaos of post-soviet life. The people he speaks for in literature have taken on the name of one of his recent novels, "Generation 'P'," P for Pepsi, not perestroika.

52 Hardin-2000, pp. 41-81.

If the Soviet and post-communist experience can teach us anything it is that we must, as Richard Ericson has put it, "abandon the Faustian urge to control, to know in advance, and thus to allow economic outcomes to arise naturally as the unpredictable consequences of market interaction."[53] At the same time, we have to redirect our efforts to questions of the institutional framework within which existing entrepreneurial activities take place and within which the continuous entry of new entrepreneurs, who will bring their fresh imagination to figure out how to better meet the demands of consumers, is encouraged.

Entry is blocked, exit is often blocked, and yet many commentators insist on calling Russia a market economy. This use of language is reminiscent of the Orwellian doublespeak of Soviet times. Is a reformer someone who claims to like reform? Is an economy a market type economy if enough periodicals and scholars call it a market? If the answer is yes, then Russia is a market economy. However, does a market economy suffer from: increasing reliance on subsistence agriculture, stifled and hidden unemployment through companies which are kept open even when they continually make losses, bankruptcies that hit companies because they have more valuable assets than other enterprises – rather than less, and the wide variety of prices that are offered for different forms of payments and non-payments (veksels, offsets, arrears, and the rare hard cash, "*zhivye dengi,*" a truly bizarre term which literally means "living money")? If the answer is no, then Russia which is plagued by all of the aforementioned problems is not yet a market economy. Searching for how Russia is moving towards or away from becoming a market, the best signal will be to follow how entrepreneurs choose to enter or exit, and not what politicians say.

53 Ericson-1991, p. 26.

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