
The Rise and Fall of State Enterprise Managers: 1994–95

The conventional wisdom about Russia in the 1990s may be summarized: “Russia had embraced big-bang market reforms but collapsed in a corrupt mess.”¹ A group of Russian communist economists and American Nobel Prize winners stated: “In spite of the hopes of the reformers for a flourishing private business which supports the economy, their program generated economic collapse, a strengthening of the mafia and growing political instability, which is destructive for the business climate.” Their key point was “the necessity to reinforce the role of the government in the process of transformation” (Bogomolov 1996, 17–18).²

This view is tainted by at least three serious misconceptions. First, as argued in chapter 3, Russia did not launch a comprehensive radical reform. Only some reform measures were radical, but virtually all of them were successful, while all “moderate” policies failed.³

Second, the reformers were in power for only half a year, from November 1991 until May 1992. How can all of Russia’s problems be blamed on them? This is a baseless accusation. From June 1992 until March 1998, the

1. Sebastian Mallaby, “Finishing What Wolfowitz Started,” *Washington Post*, May 18, 2007, A23.

2. The five Nobel Prize winners were Kenneth Arrow, Lawrence Klein, Wassily Leontief, Douglass North, and James Tobin. They were joined by John Kenneth Galbraith and Marshall Goldman (Bogomolov 1996, 21–23; Klein and Pomer 2001). Their joint declaration in apparent support of Gennady Zyuganov, the presidential candidate of the newly formed Communist Party of the Russian Federation, was published in *Nezavisimaya gazeta*, July 1, 1996, just before the presidential elections on July 3 (Mau 1999).

3. Aven (2000); Dąbrowski, Gomułka, and Rostowski (2001); Fedorov (1999a, 1999b); Mau (1999); and Yasin (2002).

government was dominated by state enterprise managers. They did issue more subsidies and impose more regulation in the name of industrial policy, which delayed economic growth in Russia until 1999.

Third, critics failed to realize that the Soviet Union had collapsed in a complete crisis and revolution, which is the ultimate state failure and made the country largely ungovernable. As Yasin (2002, 219) noted: “In 1993–94, we had in reality a ‘big and weak state’ with enormous obligations but it was unable to carry them out.”

True, Russia may be described as a corrupt mess in the mid-1990s, but it would be rash to draw any causality between “big bang” reforms and corruption. Soviet society had been a lawless kleptocracy kept in check by a ruthless police state controlled by the CPSU (Zemtsov 1976, Simis 1982, Vaksberg 1991). When the CPSU was prohibited, the repressive organs lost their authority and crime skyrocketed in the absence of order.

Reforms continued until late 1993, but then enterprise managers took over the Russian government, minimizing reforms for nearly five years. Privatization was the only reform that continued. The problem was not that reforms were too radical, but that they were partial and halted halfway, and that the dominant policy aimed at rent seeking, not radical market reform. The financial crash in August 1998 made the social costs of delaying fiscal and regulatory reforms obvious to a broad Russian elite.

This book divides the half decade of minimal reforms in 1994–98 into two periods: 1994–95, when the state enterprise managers dominated Russian politics and economy, discussed in this chapter. The period 1996–98, when the new big businessmen—the oligarchs—got the upper hand is discussed in chapter 5. This chapter first discusses the new 1993 constitution. It examines the December 1993 elections and argues that their main outcome was the formation of a government dominated by state enterprise managers. Next, we look at how the state managers ruled, noting that they were inveterate rent seekers who paid little attention to anything but material gains for their narrow interest group. Gazprom, the state-dominated natural gas monopoly, was the managers’ commanding height.

Although this was a somber period, two major reform policies advanced. One was mass privatization, which was concluded in 1994 (discussed in chapter 3). The other was temporary financial stabilization, which was accomplished in early 1995. This period also saw two repulsive developments: the rise in organized crime, and the first Chechnya war, which was initiated at the end of 1994 by the “Party of War” close to Yeltsin.

The New Constitution

The shootout at the White House was a serious trauma for the new Russia.⁴ Yeltsin’s rationale for his actions was comprehensible, but the bloodshed

4. The main sources for this section are McFaul (2001), Remington (2006), and Sheinis (2004).

seemed excessive. Democracy was supposed to be peaceful, and Yeltsin was ultimately responsible for having failed to maintain law and order. During the last quarter of 1993, Russia was ruled by decree, which became a free-for-all. The reformers pushed through many reforms that they had long prepared. Yegor Gaidar, who was back as first deputy prime minister, saw this as a great opportunity lost: “We might swiftly, without fear of organized opposition, have begun a reform of the armed forces, reduced the size of the standing army. . . . We should have seized the lever of control at the KGB, which had not been working for Russian democracy. And we should have made radical personnel changes. . . .” (Gaidar 1999, 266).

The rent seekers took care of their own interests. Prime Minister Viktor Chernomyrdin took the opportunity to pass an omnibus decree giving Gazprom all imaginable benefits. Rule by decree broke down government coordination. Many presidential decrees, often contradictory and easily changed or forgotten, were not respected. Because the decrees were not discussed in any broader community, as is the case when a law is prepared in a parliamentary committee, they often lacked support. Through its shortcomings, rule by decree showed the efficacy of the alternative—legislation by parliament (Remington, Smith, and Haspel 1998).

This was the obvious moment for Yeltsin to choose between democracy and authoritarianism. Between World Wars I and II, several fledgling Eastern European democracies collapsed at such moments. Yeltsin, however, unequivocally chose democracy. Despite, or perhaps because of, the many accusations that he had dissolved parliament to become a dictator, Yeltsin held parliamentary elections exactly as he had promised when he dissolved the Congress of People’s Deputies. He proposed a presidential system with a bicameral parliament called the Federal Assembly, consisting of the State Duma and the Federation Council. Although the atmosphere was bitterly divisive, Russia held a referendum on a new constitution and elections to the new State Duma and Federation Council on December 12, 1993. Yeltsin no longer saw any need to negotiate the electoral rules, and imposed them by decree instead.

The presidential system put in place by Yeltsin gave the president strong powers, exceeding those of the US president, especially because they were less firmly regulated. This system is commonly called superpresidential. The president had the right to nominate the prime minister, but the parliament must approve him. If it refuted the president’s candidate three times, the president had to dissolve the Duma. If the Duma passed two votes of no confidence in the government within three months, the president must either dismiss the cabinet or dissolve the Duma. The president could veto a law passed by the parliament, but the parliament could override a veto by a two-thirds vote in each chamber. The new constitution also limited the scope of impeachment to high crimes (Remington 2006, 58).

The prime minister appointed the ministers, who did not require Duma approval. In addition, the president named the so-called power ministers:

the minister of defense, the minister of interior, and the chairman of the Federal Security Service (FSB, the old KGB). He also appointed the minister for foreign affairs. These ministers reported directly to the president. In effect, the president was responsible for foreign and security policy, while the prime minister took care of economic policy. This division of labor worked well with Yeltsin and Chernomyrdin. Scared by the many problems he had had with his earlier vice president, Aleksandr Rutskoi, Yeltsin abolished that post altogether (McFaul 2001, 211–13).

The lower house of the new parliament, the State Duma, had 450 members. Half were elected in a proportional election every four years through party lists, with a threshold for representation of 5 percent of the votes cast. The other half was elected in one-mandate constituencies through a first-past-the-post system. The reason for this mixed system was a fear that Moscow would be too dominant in a purely proportional system.⁵ The proportional elections were designed to support the development of parties. The Duma confirmed the prime minister, legislated, and adopted the budget, performing the functions of a normal parliament. Its size was customary, and Gorbachev's strange innovation with indirect election to an inner parliament was terminated.

The upper chamber, the Federation Council, was never taken seriously. It was somewhat inspired by the US Senate but probably more by the German Federation Council, and its aim was to reinforce the representation of the regions. Yeltsin had created this body in the summer of 1993 in an endeavor to gain regional support. It was composed of 178 members, two from each of the 89 regions. The constitution did not specify whether they would be elected or appointed, and the system changed all the time. In 1993, two representatives from each region were elected, but hasty elections in parallel to the far-more-important Duma elections virtually guaranteed the dominance of the regional rulers over the Federation Council. From 1995, the regional governors and the chairs of the regional legislative assemblies were automatically members of the Federation Council. In 2000, President Putin usurped the right to appoint them (Remington 2006, 68).

The Federation Council never had much of a role, functioning more as a house of lords than a legislature. Usually, its members did not represent parties but rather their regions, or, in reality, certain business groups, and usually it voted obediently with the Kremlin. Consequently it attracted little interest. It met about one day every two weeks to obediently approve legislation passed by the Duma.

The federal system was replicated at the regional level. Governors were elected, and they played the role of president in each region. Regional Dumas were also elected, with all the regional deputies being elected in

5. Such a system was introduced in 2007, when the threshold for representation was raised to 7 percent, but then its prime purpose was to block the entry of new parties and independent candidates.

one-man constituencies, where parties played no role. They tried to check the governors, but not very successfully, because the governors controlled all resources.

Russia's Constitutional Court had sided with the Supreme Soviet in 1993, which Yeltsin bitterly deplored. He accepted the formation of a new Constitutional Court, but he wanted safeguards. The court was enlarged to 19 members. The president nominated all the judges, and the obedient Federation Council, rather than the oppositional Duma, was to approve them. Just in case, Yeltsin delayed its formation so that it could hold its first meeting only 15 months after the first Duma elections (McFaul 2001, 212).

The locations of the new institutions clarified the real distribution of power. The president sat in the Kremlin and his administration in the old Central Committee headquarters at the Old Square. The government was far away in the grand White House, which had been evacuated by the parliament. The State Duma moved into the old Gosplan headquarters close to the Kremlin, making evident that pure politics was to be pursued between the Kremlin, the Old Square, and the Duma. The Federation Council moved between two not very prominent places on the Boulevard Ring, indicating its insignificance.

The Yeltsin constitution was a great improvement over the dysfunctional Brezhnev constitution. It contained all the requisite institutions and a reasonably clear division of power, even if it was tilted to the president, and it provided reasonable constitutional stability. All branches of government were allowed to introduce legislation, and normal legislative work started as intended in the new Duma.

Yet, the new constitution left much to be desired. Worst of all, the presidential administration reproduced the Central Committee apparatus of the CPSU in whose premises it sat. Similarly, the gubernatorial administrations behaved like the old regional party committees, in whose buildings they were housed. The same people returned to their old offices, and they worked with the same old methods, commanding people through phone calls without legal basis, transparency, or accountability. The strong presidential system led to the preservation of many of the worst features of Soviet political management.

The presidential administration was very wealthy because of its confiscation of the real estate of the CPSU. Pavel Borodin, a former party official from Yakutsk in Eastern Siberia, was the Kremlin's long-time property manager (1993–2000). He was also a drinking pal of Yeltsin and long seen as the master of corruption in the Kremlin. At the end of the 1990s, Borodin boasted about its property being worth \$600 billion. Although this was an exaggeration, it was worth billions of dollars and it was used at the discretion of Borodin, who was the focus of major Swiss money-laundering charges in 1999 because of accusations of having taken kick-backs of \$25 million for the renovation of the Kremlin. Every year, the Kremlin distributed some 2,000 luxurious apartments in the center of

Moscow worth anything from a quarter of a million to a million dollars and 14,000 dachas (Baker and Glasser 2005, 48, 91; Klebnikov 2000, 219, 295). A senior official could obtain such a once-in-a-lifetime apartment for free, but Borodin's administration used this for blackmail, corrupting the government from within. At the regional level, the governors indulged in the same corrupting practices.

The best feature of the new constitutional order was probably the new State Duma, which became an ordinary parliament, but the persistence of single-man constituencies undermined the development of normal political parties. The Federation Council never found any useful function and it has stayed superfluous, which has inspired repeated experiments with a consultative State Council, a Public Chamber, and other futile consultative bodies. The Constitutional Court has been too subordinate to the president to be taken seriously. The legal immunity of parliamentarians was attractive to some hard-core criminals who bought seats in both chambers of parliament for up to \$10 million in the late 1990s.

The December 1993 Elections and the End of the Reform Government

The December 1993 elections were perfectly democratic and campaign expenditures modest, although the electoral rules were dictated in presidential decrees. Yeltsin's highest priority was the ratification of his new constitution, and he had decreed that it must be adopted through a popular referendum. To boost participation in the referendum, Yeltsin favored the holding of parliamentary elections at the same time. During the election campaign, Yeltsin made only one appearance on national television for 10 minutes, and he spoke about nothing but the constitution (McFaul 2001, 215–16). Yeltsin's constitution was approved in the referendum with 58.4 percent of the 54.8 percent who voted, according to the official figures that were disputed (Remington 2006, 58).

The first parliament was perceived as provisional, because it was elected for only two years, whereas future terms would last for four years. Before the December 1993 elections, a large number of new parties were formed. Opinion polls predicted a healthy majority for the two liberal parties, Russia's Choice (Yegor Gaidar) and Yabloko (Grigory Yavlinsky), but the results were a rude surprise.

The winner was Vladimir Zhirinovskiy, whose misnamed Liberal Democratic Party won 22.8 percent of the proportional vote. Russia's Choice came second with 15.4 percent, the newly formed Communist Party of the Russian Federation (Gennady Zyuganov) third with 12.4 percent, and Yabloko obtained a paltry 7.8 percent (see table 4.1).

The first impression was that the elections dealt a big blow to the reformers, but that reflected exaggerated expectations. The new Duma was

**Table 4.1 Results of election to the State Duma,
December 12, 1993**

Party	Percent of votes
Liberal Democratic Party of Russia	22.8
Russia's Choice	15.4
Communist Party of the Russian Federation	12.4
Women of Russia	8.1
Agrarian Party	7.9
Yabloko	7.8
Party of Russian Unity and Accord	6.7
Others or against all	18.8
<i>Voter turnout</i>	54.8

Sources: Åslund (1995, 200); Colton (2000, 231).

fragmented, with 11 different factions. Closer scrutiny revealed that it was most of all centrist. It was approximately equally divided between three camps: a red-brown communist and nationalist bloc (40 percent of the seats), liberals (30 percent), and centrists (29 percent), although some deputies changed factions, and the factions shifted political positions (Åslund 1995, 200–201).

The shock was the electoral success of the previously obscure Zhirinovsky and his seemingly hard-core nationalism. His party had been one of the first independent political parties to be registered in the Soviet Union, and it was widely known to be a KGB creation (Klebnikov 2000, 57). He campaigned as a hard-line Russian nationalist, but he did not hide that his father was Jewish, and he performed like an eminent stand-up comedian appealing to the cruder part of the male working class. Zhirinovsky soon made clear that his votes were for sale and the government was his preferred customer. Over time he became a steady supporter of any government, but for a solid fee. Later, he played a prominent role in the corrupt United Nations oil for food program in Iraq, which he took pride in as a matter of trade promotion.

Neither the liberals nor the communists or nationalists were to play much of a role in the future government, which reflected the balance point of the new Duma. This was a coalition of state enterprise managers, who were the chief lobbyists of the dominant industries. Prime Minister Chernomyrdin, who had been confirmed by the old parliament in December 1992, just stayed in office, although he had not run in the election. He faithfully represented the energy industry. His first deputy was Oleg Soskovets, who supervised and lobbied for the metals industry. A third influential member of the government was Deputy Prime Minister for Agriculture Aleksandr Zaveruyukha from the procommunist Agrarian Party,

who represented the *kolkhoz* chairmen. These were the three strongest industrial lobbies at the time, and they dominated government policy. A lone reformer, Anatoly Chubais, stayed on as deputy prime minister and minister of privatization and was authorized to complete the voucher privatization. The other reformist deputy prime ministers (Gaidar and Boris Fedorov) were compelled to leave.⁶

Yeltsin respected Chernomyrdin as a serious professional and an able manager, but they were never close personally. When you met both of them together, the tall Yeltsin spoke and the small, round Chernomyrdin said politely nothing, knowing his master and patently loyal to the Quixotic Yeltsin. Chernomyrdin was a technocrat of the old school, a good manager who attracted devotion from his subordinates. He was a hard worker but a poor speaker, charmingly mangling his words. His most famous phrase, which unfortunately captured the essence of his long tenure as prime minister, was: "We wanted to do the best, but it turned out as always."

Chernomyrdin's challenger and first deputy, Soskovets, was a personal friend of Yeltsin, Yeltsin's chief bodyguard Aleksandr Korzhakov, and Korzhakov's KGB sidekick, Mikhail Barsukov, soon to become chairman of the Federal Security Service (1995–96). This tightly knit trio formed the central part of Yeltsin's *banya* team and of state power from 1993 until their ouster in June 1996. Soskovets had made his career as manager of the giant Karaganda metallurgical company in Kazakhstan and he was a successful rent-seeking businessman in the metals industry connected with the worst organized criminals in the bloody aluminum war (Dixelius and Konstantinov 1998, 137–39; Klebnikov 2000, 307–13). In early 1993 he surged as deputy prime minister of Russia and as a personal favorite of Yeltsin. Persistent rumors had it that Yeltsin was about to replace Chernomyrdin as prime minister with Soskovets. This trio dominated the military and law enforcement, over which Chernomyrdin held no sway. Korzhakov built up a powerful and independent presidential security service using all secret police methods. In his business, Soskovets made use of Korzhakov and Barsukov's forces and taught them how to transform their power into money. The story about their deeds remains to be written, and it will be one of the most unsavory parts of Russia's post-Soviet history.

Pavel Grachev, minister of defense 1992–96, was one of their close friends. As a paratroop general, he had won Yeltsin's heart by refusing to attack Yeltsin and the White House in August 1991. However, he was nicknamed "Pasha Mercedes," because he was considered to have led the looting of the huge Soviet arms depots in East Germany. A journalist with the newspaper *Moskovsky Komsomolets*, Dmitri Kholodov, was killed by a

6. In January 1994, Gaidar, Fedorov, Chernomyrdin's economic advisor Andrei Illarionov, and foreign economic advisors Jeffrey Sachs and myself resigned from our posts. We tried to make a maximum amount of noise in order to alert people about the unfortunate course of the new government.

bomb in a briefcase in October 1994 when investigating these charges (Klebnikov 2000, 41–42). Several military officers were prosecuted for this murder, but they were acquitted, and their superior, Grachev, escaped unscathed.

The State Enterprise Managers

The first half of the 1990s marked the peak of the power and status of state enterprise managers. They had everything going for them. Within the old *nomenklatura*, they were the most reformist, devoid of ideology and opposed to violence. Ryzhkov had replaced most enterprise managers in 1985–87 with professional engineers in their 50s. They had an air of competence, being pioneers in adjusting to the market, and they accepted privatization.

The managers were also the best-organized interest group. Their chief organization was the Russian Union of Industrialists and Entrepreneurs (RSPP), which was founded and chaired by Arkady Volsky, one of the most liberal and savvy senior officials of the Central Committee of the CPSU. Another important organization was the Association of Russian Banks. In a time of nearly complete fragmentation of society, the managers were perfectly organized, just as Mancur Olson (1971) predicted of small groups with much to gain from collective action.

The state enterprise managers were the masters of the transition period, enriching themselves at the expense of state and society. As the foremost rent seekers, they were the main obstacle to financial stabilization, because they fought for subsidized credits and large subsidies from the state budget, which destabilized Russia's state finances. Chernomyrdin led them in declaring in July 1994 that while it was good that inflation had fallen to 5 percent a month (80 percent a year), stabilization policies bringing down inflation to 2 to 3 percent a month were unacceptable. According to Chernomyrdin, such a decline would have harmed the investment climate (Institute of Economic Analysis 2004). He supported Viktor Gerashchenko, chairman of the Central Bank, and his loose monetary policy.

The enterprise managers had a rational but complex approach to price regulation, being interested in any price distortions on which they could make money through arbitrage. Usually, they favored high prices on their output, but state managers in energy and agriculture called for low state-regulated prices for their produce, because they were traders, making their fortunes on buying these products cheaply and selling them at high international prices for personal benefit. Meanwhile, they claimed they protected the living standards of the population.

The RSPP sponsored a political party called the Civic Union, which was one of the strongest factions in the center of the Russian parliament in the second half of 1992. When it faced the electorate in 1993, however, the

Civic Union received no more than 2 percent of the popular vote, showing that the RSPP's strength lay in the political establishment, not in popular support.

The people in the countryside, by contrast, supported the Agrarian Party. After the parliamentary elections in December 1993, it used its newly won parliamentary strength of 12 percent of the seats to lobby for an omnibus decree on the agro-industrial sector, which Chernomyrdin signed. It prescribed subsidies and regulations: large centralized credits, plan targets for 10 major agricultural products (giving the agrarians bargaining chips against the state), and some trade monopolies. Still, marketization proceeded, and soon Russia's chronic grain shortage was history. Eventually, the producers revolted against the semi-state procurement companies and their artificially low state procurement prices. Russia introduced substantial import tariffs for agricultural goods in July 1994. Market developments were sufficient even in agriculture to break the unity of the strong agrarian lobby (Åslund 1995, 165–66).

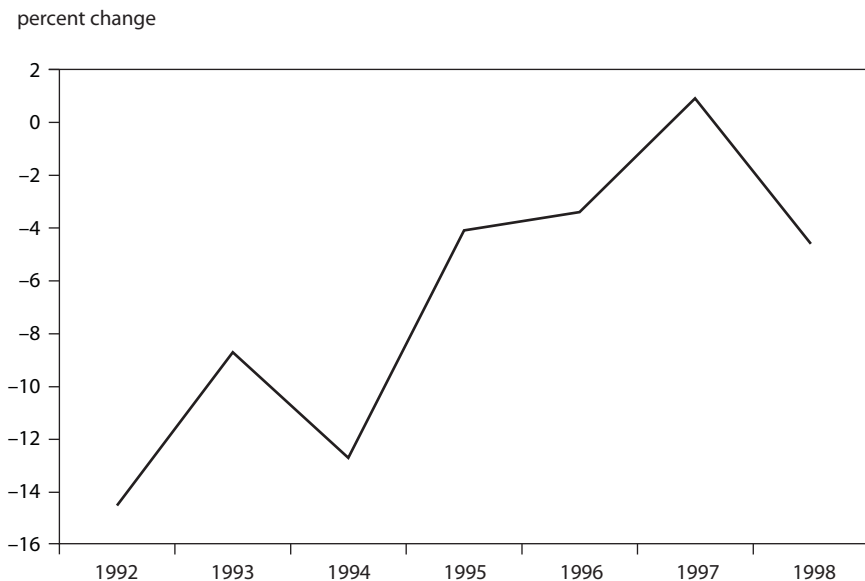
Soskovets pampered the metallurgical industry, for which he secured substantial tax exemptions of about 2 percent of GDP. His main trick was to exempt metal trade from the value-added tax and foreign trade taxes through barter deals. Metallurgical companies used transfer pricing, buying inputs abroad for a higher price than the ruling world market price and selling them at a lower price, leaving their profits in a trading company in an offshore tax haven (Bagrov 1999).

Initially, mass privatization had aimed at containing the power of state enterprise managers. The privatizers' slogan—"what is not privatized will be stolen"—had been directed against the managers who controlled the state enterprises since the Law on State Enterprises had come into force in 1988. Although Chubais managed to limit their share of ownership to about one-fifth after the voucher auctions, the managers still controlled most enterprises by acting as proxies for the 40 percent of shares usually held by their employees.

In early 1994, the managers appeared to have won a complete victory. They controlled the government and the strongest interest organizations. They had conditional ownership of most big enterprises, and they had manipulated fiscal, monetary, and regulatory policies to their benefit. Yet, their weakness was that they were the masters of transition, which could not last forever.

Their most profound problem was that they did not know how to manage their enterprises in a market economy. Output continued to fall, and the official slump actually accelerated to 13 percent in 1994, almost as bad as in 1992, because hard budget constraints were not imposed (figure 4.1). The idea of financial stabilization was that money would become scarce, so that managers had to cut costs, sell off inventory and surplus supplies, cut prices in competition, and expand sales by producing more of their best products.

Figure 4.1 Decline in Russia's GDP, 1992–98



Source: Goskomstat (2000, 16).

Now, the opposite was happening. The managers trusted their friends in government to keep them afloat with subsidies. As the prospect of financial stabilization became more distant, they delayed enterprise restructuring. Increasingly, managers paid neither their taxes, bank loans, nor suppliers, accumulating large arrears. They hoarded workers as in Soviet times to extract more subsidies, which impeded the expected unemployment, but they cut real wages and caused chronic wage arrears and poverty. Many state-owned and insider-privatized enterprises came to a standstill in spite of large capital investment financed with subsidized state credits.

This irresponsible and parasitical mismanagement could not go on forever. Over time, many managers lost out. After several years little remained of their enterprises, and many failed completely. This was desired creative destruction (Schumpeter 1943/1976), because Russia had far too many industrial enterprises, with too large a physical capital, and most of them were obsolete. Production needed to be concentrated and expanded at the best companies (McKinsey Global Institute 1999).

In public utilities, telecommunication firms, and metallurgical companies, however, the asset values were great and the stock prices of the companies rose. Outsiders tried to buy such companies. They approached embryonic local stock dealers, who parked a bus outside the factory gates and announced that they would buy the workers' stocks at a good price. Work-

ers sold their shares en masse, and outside raiders could mount a hostile takeover with majority ownership. Often, the raiders needed to enter the company with their own security guards and seize the assets physically to stop the incumbent managers from destroying the plant. Between 1992 and 1996, 33 percent of Russia's large and medium-sized enterprises changed management and underwent substantial restructuring (Blasi, Kroumova, and Kruse 1997, 203). Voucher privatization worked, but the positive effects were often delayed by several years. Young outside entrepreneurs, or raiders, gradually undermined the dominance of the old managers.

The Making of Gazprom

Gazprom was the mightiest of all Russian corporations, and it was ruled by its managers.⁷ In 1985, Prime Minister Ryzhkov had appointed an outstanding young (47-year-old) gas engineer, Viktor Chernomyrdin, as Soviet minister of the gas industry. When the ministry was abolished in 1989, it was transformed into the state gas concern Gazprom, which was the customary first step in a spontaneous privatization. It kept all its assets, and Chernomyrdin remained its head.

When Yeltsin appointed Chernomyrdin as deputy prime minister for energy in May 1992, he had to leave Gazprom, but he passed on the top job to his protégé, Rem Vyakhirev. As deputy prime minister and later as prime minister, Chernomyrdin continued to protect Gazprom's interests to quite an extraordinary extent. In November 1992, a presidential decree transformed Gazprom into a joint stock company, strengthening its legal status.⁸

Almost all other old industrial ministries and enterprise associations were divided into individual enterprises as an initial step toward corporatization and privatization, but Gazprom was exceptionally corporatized as one company that included literally all enterprises and institutions dealing with gas: producing companies, refineries, pipelines, trading companies, the gas foreign trade company, all regulatory agencies, teaching and research institutes, and even 200 state farms. It employed about 400,000 people.⁹

After the Congress of People's Deputies was dissolved in September 1993, the reformers carried out all kinds of deregulation that had previously been politically impossible, but Chernomyrdin sponsored a decree that guaranteed Gazprom a complete monopoly on the production, sale, transport, and export of natural gas. The gas industry was the most mo-

7. A general source for this section is Stern (2005).

8. Information from Gazprom's website, www.gazprom.ru (accessed on May 31, 2007).

9. The railways and the nuclear industry remained ministries without corporatization for years. Telecommunications and public utilities were divided by regions and partially privatized. The oil and coal industries were divided into enterprises.

nopolized and regulated industry in Russia, while all other industries had undergone substantial liberalization. Natural gas exports were subject to licenses and quotas, but Gazprom itself was exempt from the export tax, some import tariffs, and the value-added tax (VAT) (Åslund 1995).

All Russian energy prices were regulated and extremely low in 1992. As head of Gazprom, Chernomyrdin did not advocate higher gas prices. Nevertheless, in 1994, he stated that a fundamental mistake of the first reform government was its failure to liberalize energy prices at the beginning of the reform. The price of natural gas remains regulated, and it has been raised only gradually, reaching one-fifth of the European import price by December 1993 (Åslund 1995, 158–61). After considerable fluctuation, the gas price remained about one-quarter of the European import price in 2007. Its pricing was nontransparent, and price regulation and discrimination persisted.

The value of the tax exemptions awarded in late 1993 amounted to 1 to 2 percent of GDP, when Gazprom's share of Russian net value added was about 8 percent of GDP (Bagrov 1999). Russia's wealthiest company was barely paying any taxes. Gazprom's gas production declined by only 4 percent (BP 2007), while the official decline in Russia's GDP was 44 percent from 1989 to 1998 (UN Economic Commission for Europe 2004, 80), although the real GDP decline was probably only about half of the official total (Åslund 2002). Consequently, Russia had a substantial surplus of gas in the mid-1990s. As a monopoly, it prohibited both domestic oil companies that produced associated gas and Turkmenistan from transporting their gas through Gazprom's pipelines. The oil companies had to flare about 20 billion cubic meters of gas each year, whereas Turkmenistan was subject to a complete embargo for a year and a half over 1997–98 and could export no gas until it built a pipeline to Iran. Given the monopoly and the arbitrary pricing, no domestic market could develop. Even in 2007, gas was allocated by administrative fiat as in Soviet times (Åslund 1995, 159; Olcott, Åslund, and Garnett 1999).

Gazprom was privatized in a unique order in 1993–94. Its management used the voucher auctions to privatize almost 40 percent of Gazprom shares for an implied price of about \$100 million (Klebnikov 2000, 134–35; Stern 2005, 170–71). Of all Russia's privatizations, this was the biggest giveaway, because these shares cost one thousand times more, \$100 billion, in 2006. In 1994, Prime Minister Chernomyrdin appeared to have time for nothing but Gazprom privatization. The stocks were given away for a nominal fee to Gazprom managers, senior officials, and employees—altogether half a million people—but not at all evenly.

At the time, it was rumored that Chernomyrdin and Vyakhirev each received 5 percent of the shares, which Chernomyrdin publicly denied. If that were actually true, and if they still possessed these shares in 2007, each would own about \$13 billion. Cleverly, Gazprom gave stocks to many top people in the Kremlin, wedding them to the enterprise's interests.

To make sure that they did not lose control over the company, no stocks could be traded without permission from the Gazprom board, and they could be owned only by Russians. Furthermore, nearly 60 percent of the company stayed state-owned or owned by Gazprom subsidiaries. In 1996, 1 percent of the shares was sold in the West, where they traded at a much higher price until 2006, when domestic and foreign shares were unified. Lukoil and Surguteftegaz, two large oil companies, were also privatized by their skillful managers, Vagit Alekperov and Vladimir Bogdanov, respectively.

In spite of having powerful shareholders and a major international company as auditor, Gazprom management held shareholders in utter contempt until it was ousted in 2001. Instead of boosting the stock price, management focused on making money in unfortunate ways. In the second half of the 1990s, the biggest boondoggle was exports to other countries in the Commonwealth of Independent States (CIS), notably to Ukraine.

A private middleman, Itera, emerged to pursue this trade on behalf of Gazprom. Itera had originally been an independent company, but came to represent the interests of Gazprom management. Gazprom sold gas to Itera for \$4 per 1,000 cubic meters (mcm) for export to Ukraine, which formally bought the gas for \$80 per mcm. But the actual price Ukraine paid was about \$42 per mcm. National sentiments were mobilized. Russians complained that Ukraine did not pay, while the Ukrainians lamented that the Russian price was outrageous. In reality, Itera cashed in on a couple of billion dollars each year and Ukrainian gas oligarchs made about as much in great friendship (Åslund 2001, Balmaceda 1998).

At the end of the 1990s, Gazprom management opted for large-scale asset stripping, transferring large properties such as gas fields to Itera and other companies owned by close relatives of the leading Gazprom managers (Stern 2005, 22–24). This took place after Chernomyrdin had been dismissed as prime minister in March 1998, and Gazprom management had good reason to fear losing control over the corporation.

Gazprom was Russia's foremost rent-seeking machine, but it remained respected for several reasons. It kept up production, allowing Gazprom to continue delivering gas to enterprises and households even when it was not being paid. It was Russia's largest exporter. When much of Russia's heavy industry plunged into murderous shootouts, Gazprom retained a veneer of peace and order. It was an idyllic Soviet theme park with wonderful holiday homes and social benefits.

Precarious Financial Stabilization

The dominant lobbies used the state treasury as a self-service boutique, keeping the ministry of finance weak. After their unpleasant experiences with the ebullient Boris Fedorov, they made sure that no permanent min-

ister of finance was appointed, leaving First Deputy Minister Sergei Dubynin as acting minister. At the Central Bank, Gerashchenko was reliably accommodating. The budget balance was gradually undermined.

A shock hit on “Black Tuesday,” October 11, 1994, when the exchange rate of the ruble fell precipitously by 27 percent in a single day. One year earlier, the exchange rate was of little concern, but now it had assumed real economic significance, because Russia had become a market economy. Powerful economic interests had become used to a reasonably stable and predictable exchange rate, and its mismanagement—or more likely, manipulation—aroused a popular outcry.

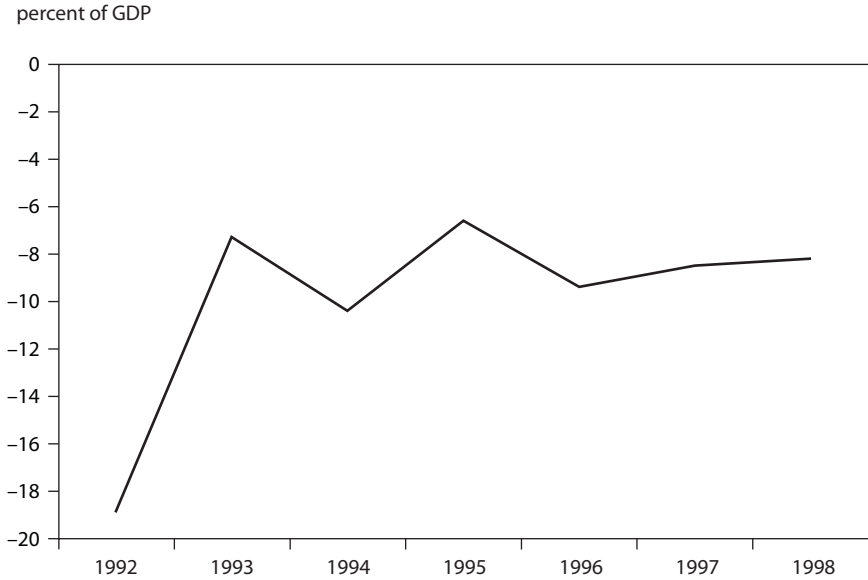
The currency crisis shook the Russian establishment out of its complacency with the stalled stabilization effort. The State Duma launched a vote of no confidence against the government, which the government survived by a slight margin. The main beneficiaries of a low exchange rate, the commodity traders, were no longer the dominant force in Russian business, as their rents were drying up, whereas the bankers were advancing. The leading economic policymakers, including Gerashchenko (but not Chernomyrdin), were sacked by President Yeltsin. Instead, Chubais was put in charge of macroeconomic policy as first deputy prime minister, and the old liberal reformer Yevgeny Yasin became minister of economy. Chubais attacked this task with his usual vigor and astuteness.

The key to macroeconomic stabilization was fiscal adjustment. Chubais focused on cutting enterprise subsidies, which were reduced by no less than 7.1 percent of GDP. The other important item to be slashed was regional transfers, by 2.5 percent of GDP, while socially important expenditures were maintained (Åslund 1999). As a consequence, the general government deficit fell from 10.4 percent of GDP in 1994 to 6.6 percent in 1995 (figure 4.2), but revenues declined by 3.6 percent of GDP as budget constraints tightened. For the first time, Russia concluded a full-fledged standby agreement with the IMF, with \$6.8 billion in financing in one year. In the spring of 1995, macroeconomic stabilization was finally put on track. By the summer of 1996, financial stabilization had been attained. Inflation dropped to 22 percent in 1996 and to 11 percent in 1997 (figure 4.3).

The Russian financial stabilization appears a political paradox. How could the government undertake financial stabilization by cutting enterprise subsidies when it was dominated by these lobbies? The explanations are multiple. First, most of the old, large rents were gone. Subsidized credits and import subsidies had been eliminated, and export rents were small. The sharp cut in subsidies made profit seeking more lucrative than rent seeking, allowing a new profit-seeking lobby to defeat the rent-seeking lobby.

Second, at long last the government and Central Bank coordinated their economic policy and both aimed at macroeconomic stabilization. Third, for the first time, the IMF was considering substantial credits, and its standby loan for 1995 amounted to 2 percent of Russia’s GDP, which gave the IMF

Figure 4.2 Consolidated state budget deficit, 1992–98



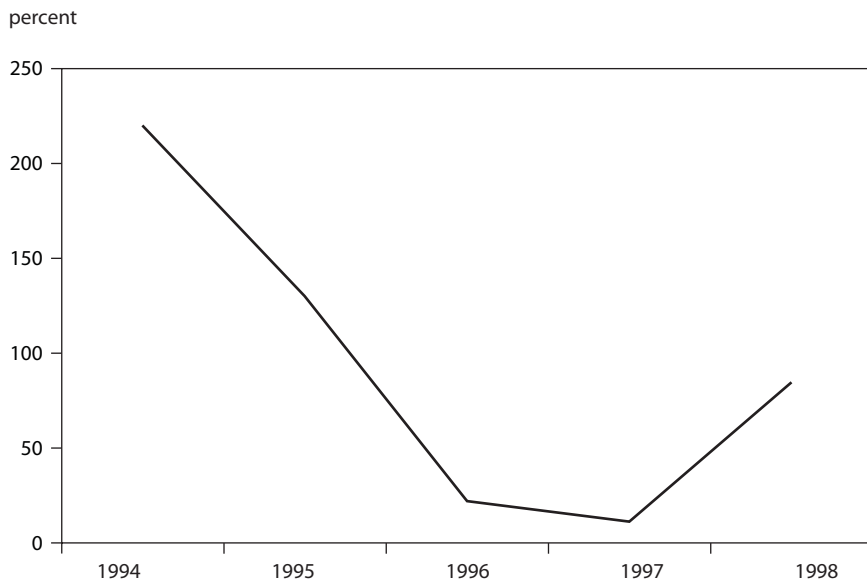
Source: EBRD (2000, 68; 2003, 187).

real leverage in Russian politics. With strong IMF support, Chubais won over Soskovets within the government (Bagrov 1999). Fourth, the currency crisis of October 1994 greatly upset the Russian elite, which had developed an interest in economic stability, creating a political momentum for reform.

Fifth, the reformers in the government fought better than ever, because they hit all important interest groups hard and fast rather than negotiate with them or offer any trade-off. Enterprise subsidies and regional transfers were cut by two-thirds, delivering true shock therapy to those who lived on budget subsidies. Once again, reforms were more easily undertaken when they were straight, simple, and hard. The harshness of the government convinced the “victims,” who were resourceful rent seekers, that they had better find a new strategy for making money. Sixth, Gaidar’s party, Russia’s Choice, was the largest parliamentary faction, providing the reformers with a strong base in the State Duma.

Treisman (1998) and Shleifer and Treisman (1998, 2000) have presented an additional explanation. Many bankers were enticed by a new rent, excessive yields on treasury bills, which turned their interest to low inflation and a stable exchange rate. Meanwhile loss-making enterprises started living on arrears, which were indirect and noninflationary subsidies instead of inflationary budget subsidies. The authors concluded that the Russian reformers lured the winners from inflationary partial reform with a less inflationary form of rent to give up their previous inflationary rents. How-

Figure 4.3 Inflation rate, 1994–98



Source: Goskomstat (1999, 547).

ever, this appears a rationalization in hindsight, because the timing does not match. In early 1995, the reformers divided the business community by driving rents down. The new rents mounted later, as the stabilization program was being undermined, and they were not part of the stabilization deal of March 1995. Still, Shleifer and Treisman rightly pointed to the rise of the bankers who thrived on the high yields of treasury bills, and to the decline of the state enterprise managers who lived on other forms of rents.

Alas, this cure was only temporary, because no lasting fiscal adjustment was accomplished. The yields on the treasury bills were moderate only briefly in 1997, and they were the direct cause of the financial crash in 1998. Rent seeking through extremely high treasury yields was no exit from fiscal jeopardy but a trap. Successful reforms, as in Poland and Estonia, beat rent seekers by changing the rules of the game once and for all, enticing businessmen to opt for profits rather than new rents. The purpose of reform is to defeat rent seeking and establish a more productive set of incentives. It would be both illogical and defeatist to think that one can make people honest only by bribing them, even if that were true of the stakeholder privatization. The Treisman-Shleifer hypothesis belongs to the popular political science idea of trade-off, against which stands the idea of a changed paradigm and ideology (Åslund 1992, Appel 2004).

The sudden and radical cut in subsidies was quite a blow to the old rent seekers. They were left in disarray, which demonstrated that the smaller

their rents, the less their political power. Financial stabilization also divided the powerful Association of Russian Banks. When the interbank market dried up in the fall of 1995, financially strong banks did not call for state support but tacitly favored the bankruptcy of their competitors. A new generation of private bankers took over from the old state bankers, facilitating change (Dmitriev et al. 1996). Similarly, the old red directors lost ground to new businessmen. This is how shock therapy reforms should work. By changing the paradigm and the rules of the game, businessmen were enticed to switch from rents to profits, thus breaking up the rent-seeking lobbies.

The Rise of Organized Crime

To ordinary Russians, one of the worst shocks of the transition was the explosion of crime that started in 1989–90.¹⁰ Initially, crime was not localized but erupted everywhere. Gangster shootouts occurred in local shopping centers all over the country. In 1992 and 1993, automatic gunfire could be heard every night in the center of Moscow. St. Petersburg was named Russia's crime capital. Seemingly meaningless murders became so common that everybody knew people who had been killed.

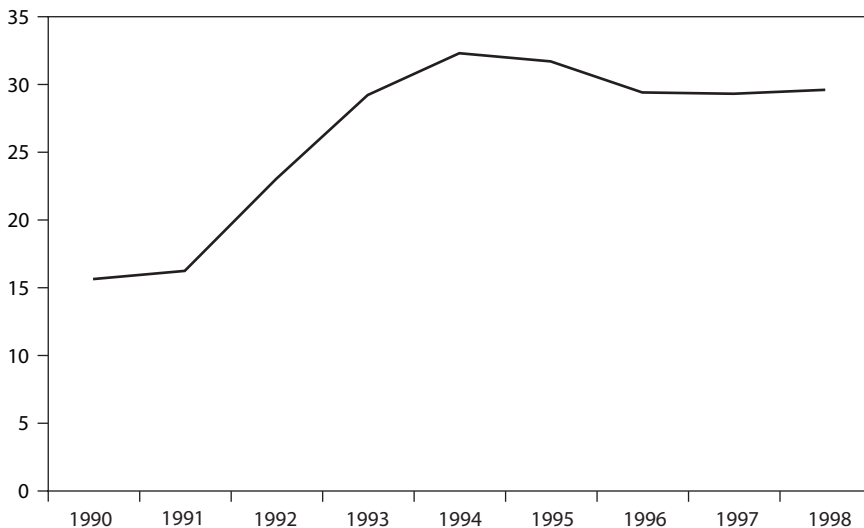
During the transition, crime was greatly redefined when communist crimes, such as "speculation" (that is, trade), were legalized, whereas corruption was criminalized. The reporting and registration of crime were poor. Therefore, only statistics on major and unequivocal crimes, such as homicides, are likely to reflect what actually happened. The numbers are truly shocking. Russia's murder rate doubled in three frightful years from 1991 to 1994, peaking at the internationally very high rate of 22 per 100,000, which is nearly four times the current US homicide rate (5.6 per 100,000 in 2005 [FBI 2005]; figure 4.4). Reality was even worse. About as many people disappeared each year, and the majority of them were probably murdered (Klebnikov 2000, 32).

Shocking as the rise in crime in Russia was, it was not exceptional. Most transition countries saw a doubling of their crime rates. This rise seemed related to how the old regime eased up. A more radical reform brought about an earlier peak in crime followed by stabilization, while the gradual reformers saw a longer but steady increase. Poland and Hungary experienced the sharpest surge in their crime rates in 1990, their first year of reform, after which they stabilized (Åslund 1997). Crime doubled in Rus-

10. Russian organized crime has attracted a huge literature, some of it serious, some fiction. The main sources for this section are Volkov (2002), Gilinskiy (2000), Handelman (1995), and Dixelius and Konstantinov (1998). Organized crime has been a dominant theme in Russian fiction, films, and TV programs. A favorite of mine is Latynina (2003).

Figure 4.4 Homicides, 1990–98

total in thousands



Source: Goskomstat (2000, 243).

sia and Kyrgyzstan from 1988 to 1992, while the crime rate grew more gradually in the most conservative countries, Turkmenistan and Uzbekistan (Mikhailovskaya 1994).

What was remarkable about Russia was that crime had been extensive under the old regime but not known. In the late 1980s, Soviet Russia had as high a murder rate as the United States. The Soviet Union had the largest prison population in the world as a share of its population. In addition, it held millions in exile in faraway provinces. Therefore, criminality was relatively limited in the big cities, which created an illusion of a law-abiding society (Mikhailovskaya 1994). This Soviet illusion was reinforced by strict censorship that prohibited the reporting of crimes in the media, which glasnost ended.

The explosion of crime was a natural consequence of the breaking down of the old order. The Soviet Union was a lawless society in the exact meaning of the word: there were few laws and therefore most actions were not regulated by law. The Soviet Union compensated with its totalitarian legal principle: Nothing is allowed that is not explicitly permitted. The CPSU had effectively established norms for how far officials and managers could diverge from the legal norms, because no state company could fulfill its plan targets without resorting to the illegal acquisition of vital inputs. The vagueness of informal norms blurred the line between the permitted and the prohibited.

Therefore, the Soviet state needed a huge law enforcement apparatus that pursued violators and meted out severe punishments with minimal court proceedings. Absurdly, in the Soviet legal system prosecutors were superior to judges and defense counsels were rarely permitted. Prosecution was nearly always successful. This arbitrary system was intolerable in a liberal society, and the repressive powers of law enforcement were curtailed in the early perestroika. But it would take a long time to build a new rule of law, because it required hundreds of new laws, a complete judicial reform, new court procedures, extensive training, and substantial financing. Even in the best-case scenario, the legal reforms would take more than a decade, and the masters of the old system, the prosecutors, had all the reasons to oppose legal reforms tooth and nail (Sachs and Pistor 1997; Anderson, Bernstein, and Gray 2005).

Another frightening feature of the late Soviet Union was its massive supply of criminals. The Soviet Union had well-organized criminal syndicates that had survived from tsarist times in the prison camps. In the late Soviet period, many hard-core criminals received amnesty and moved to the big cities. The collapsing Soviet society also harbored a large number of demoralized and brutalized war veterans from Afghanistan, disillusioned police and military officers, unemployed professional sportsmen, and tightly knit ethnic minorities. Rarely has a society had such a teeming reservoir of skillful and brutal criminals. This was a cynical society with a minimum of values, where neither church nor ideals could be expected to hold criminalization at bay (Volkov 2002, Handelman 1995).

The rise of disorganized individual crime became unbearable. New businessmen complained that they were visited by so many racketeers that they did not know whom to pay, although they had to pay protection fees to save their lives. Numerous entrepreneurs saw their premises burn, which was usually the second warning, and many were killed in the end. Law and order effectively broke down as the old police stayed passive, generating great demand for protection. During 1991–92, legal anarchy, a truly Hobbesian world, prevailed. Gambetta's (1993) economic analysis of the evolution of the Sicilian mafia appears perfectly applicable. The demand for private protection, or *krysha* ("roof"), was as great as the supply, while public law enforcement was worse than useless.¹¹

Crime evolved in response to market forces and organized itself spontaneously. Through great violence, organized crime imposed its own order financed with racketeering fees, dividing cities into well-defined mafia districts. Each Russian city had its own distinct mafia gangs. They were well known, as were their leaders, and their names spoke volumes. Often they were named after an ethnic group (the Chechen mafia, the Georgian mafia, the Armenian mafia, etc.). One specific mafia was Afgantsy, Afghan

11. A young social scientist from St. Petersburg, Vadim Volkov (2002) has written an excellent analysis of the evolution of crime in Russia in line with Gambetta's analysis.

war veterans, who had their official nongovernmental organization as a formal base. Other groups were named after a sport club, and many after their specific region (Liubertsy, and the Solnechny and Izmailovsky groups in Moscow). Occasionally, a group was named after one leader (the Malyshev group in St. Petersburg) or for the origin of the leader (the Tambov and Kazan groups in St. Petersburg). The leaders sometimes became public personalities.

Businessmen actually appreciated the organization of crime that occurred in 1993–94. Now they knew whom to pay, which sharply reduced their risk of double-paying or being shot. At the same time, racketeering fees declined as the security business became standardized. Anecdotal evidence suggests that the standard fee fell from 20 to 10 percent of a businessman's turnover. The drawback, of course, was that most Russian businesses were still compelled to pay racketeering fees. The main exceptions were enterprises under solid state protection, such as those pertaining to the military-industrial complex and the Ministry of Interior. As Volkov (2002, 19) put it: "Since the actions of the state bureaucracy and of law enforcement remain arbitrary and the services provided by the state tend to have higher costs, private enforcers (read: the mafia) outcompete the state and firmly establish themselves in its stead." The state played a very small role in the early 1990s. Government officials, including policemen, were afraid and alienated, and they worked as little as possible.

The worst bloodbaths occurred in specific industries, primarily aluminum and banking. The gangster wars gave rise to a large number of detective stories, documentary "novels," and television series (e.g., Latynina 2001, 2003, 2005). One of the worst industrial battles was the "great aluminum war," which raged in 1993–94. When the Soviet Union collapsed, some traders secured control over and colluded with the managers of the state-owned aluminum plants by delivering raw materials to them through a barter arrangement. The managers felt cheated and tried to liberate themselves from the traders through privatization. Much of the bloodshed in the aluminum industry occurred when the parasitical traders tried to recuperate the plants by sending in their troops (Klebnikov 2000, 307–13; Dixelius and Konstantinov 1998, 137–39). But after privatization, these barter arrangements ended, and the traders lost out. Privatization cleansed even this most criminalized industry.

In banking, typical causes of murders were large unsecured loans that were not paid back on time. Russia's biggest car plant, Avtovaz in Togliatti, was completely criminalized in Soviet times. It has been the scene of no fewer than 500 murders, which unfortunately continue, as the enterprise has not been restructured and thus not cleaned up.

As so often in Russia's post-Soviet history, everybody threw up their hands and said that this is what Russia has become. But just as they resigned and said that nothing could be done, organized crime was about to be defeated by a combination of four forces.

First, in a masterstroke the Russian reformers legalized private security companies in 1992. Swiftly, organized crime legalized itself into private security companies, but it also exposed itself to more transparency, state supervision, regulation, and legitimate competition. Step by step, the private security companies became more orderly and legal in their activities (Volkov 2002).

Second, the dangers of organized crime were overwhelming. In 1993–94, the so-called great mob war eliminated most organized criminals. Many were killed by one another or by the police, while others were sentenced to long prison terms. The successful criminals who survived had the choice of selling out and retiring in the West or gentrifying, although few organized criminals were able to legalize themselves, and among the current 53 billionaires in Russia, only a few might have started as racketeers (Klebnikov 2000; Brady 1999, 60).

Third, the new big businessmen, the oligarchs, thought the fees of the protection rackets excessive, and they set up their own security and guard services. By the mid-1990s, 8 percent of the employees in a typical oligarchic corporation were occupied with security, either as guards or counterintelligence officers assigned to find out what their enemies were doing. The top oligarchs hired a “deputy minister of interior” to run their security and a “deputy chairman of the KGB” to manage their counterintelligence.¹² By the end of the great mob war in late 1994, the new businessmen “were powerful enough to ignore the old gangsters” (Klebnikov 2000, 44).

The new businessmen defeated organized crime also within their enterprises. A dirty secret of the old system was that Soviet enterprises were seriously criminalized (Simis 1982, Vaksberg 1991). Employees stole goods from every state enterprise and considered it their right. This was particularly true of an enterprise’s transportation and construction departments, where valuable goods came in and out. A Russian corporate raider knew that to seize control of an unstructured Soviet enterprise, he had to sack all the staff of these two departments, whereas the bookkeeping department was likely honest, because it only handled money, which was abundant in the Soviet system. Production and research and development were usually decent as well. Naturally, ruthless local businessmen with their own security forces were far superior to foreign investors in these actions.

The fourth force that contributed to the defeat of organized crime was actually the state, although it was less significant at this stage. New and more relevant legislation was being passed. The police were receiving increasing resources, and they possessed the legal monopoly on the use of violence. The return of state power was slow but relentless. “It will soon transpire, however, that public law and order is a ‘public good,’ and that it is better to pay taxes to keep an efficient municipal police than to run private or local security and guard services,” as Sergei Vasiliev (1999, 52) noted.

12. Conversations at the time with two prominent oligarchs.

Notwithstanding of the many books written about post-Soviet organized crime, it lasted for only a brief period, approximately from 1992 to 1995, although it persisted in some places. As late as 2006, the Russian city of Novgorod was run by seven organized crime gangs, and supervised by one godfather without interference from the Russian state. In general, however, by 1995, the oligarchs had defeated the worst excesses of organized crime. Russia's murder rate peaked in 1994, and it fell by 9 percent from 1994 to 1996, but then the improvement stopped, and the murder rate stabilized.

The First Chechnya War

In spite of Yeltsin's words in Tatarstan in 1990, when he told Russia's constituent regions to take as much sovereignty as they wanted, he was greatly preoccupied with the cohesion of Russia in early 1992.¹³ He aspired to define the legal and financial powers of the 89 constituent regions of the Russian Federation through a Federation Treaty signed in March 1992. Three strong autonomous republics requested special rights: oil-rich, Muslim Tatarstan and Baskhortostan (Bashkiria) on the Volga, and diamond-rich, vast Sakha (Yakutia) in East Siberia. Eventually, these three republics were accommodated in the Russian Federation after having extracted substantial privileges, and 88 of 89 regions accepted the Russian Federation. The exception was Chechnya.

Chechnya stood out for many reasons. The Chechens were Muslims and quite numerous at 1 million. They lived compactly in their own mountainous autonomous republic on Russia's border with Georgia, which made their demands for independence feasible. The Chechens were legendary for their prolonged and ferocious resistance against the Russian Empire in the 18th and 19th centuries, as detailed by the classical Russian writers Lev Tolstoi and Mikhail Lermontov. In 1944, all Chechens were deported by Stalin to Siberia and Central Asia. Nikita Khrushchev permitted them to return in 1957.

In 1991, Chechnya had its own revolution, overthrowing the Chechen communist leader. In October 1991, Chechnya held presidential and parliamentary elections. Dzhokhar Dudaev, a retired Soviet general, won the presidential elections with 85 percent of the vote and Chechen nationalist groups captured all the parliamentary seats. The new Chechen parliament declared full independence from Russia, which it confirmed in a new constitution passed in March 1992. The prior Chechen-Ingush Republic was formally divided into Chechnya and Ingushetia. Russia was faced with a full-fledged secession on its southern border. Russia refused to recognize

13. This section is primarily based on Dunlop (1998), Lieven (1998), Trenin and Malashenko (2004), and Gall and de Waal (1998).

the legitimacy of the Chechen election, fearing that ethnic separatism could lead to the disintegration of the Russian Federation, but it did not devote much attention or resources. In November 1991, Yeltsin declared emergency rule in Chechnya, and sent troops to the capital of Grozny, but they were forced to withdraw.

After this initial humiliation, the Chechen issue was put aside, but recognized as a potential cancer that could metastasize in other limbs of the country. Chechnya was poorly developed, although it possessed some oil. Many Chechens lived in Moscow, and several were quite prominent businessmen, but Moscow also harbored a large and brutal Chechen mafia. Ordinary Russians associated Chechens with violent crime.

The unresolved Chechen attempt at secession lay simmering in Russian politics. In the fall of 1994, the Kremlin tried to instigate an armed Chechen uprising against President Dudaev. Clandestinely, the Federal Security Service contributed with financial support, military equipment, and troops to opposition forces, which tried to attack Grozny in vain. Until November 1994, Moscow's military provocations in Chechnya appeared half-hearted, but then Yeltsin issued an ultimatum to Dudaev's government in Grozny to disarm and surrender. When Dudaev refused, the Russian air force started bombing Grozny, and on December 11, 1994, Russia launched a full-fledged military attack on Chechnya to restore "constitutional order," sparking the first Chechen war.

The decision to invade Chechnya was ultimately made by Yeltsin, but a distinct "Party of War" had evolved in the Kremlin. It included Yeltsin's *banya* pals, Soskovets, Korzhakov, Barsukov, Grachev, and other power ministers. Prime Minister Chernomyrdin and the civilian part of the government were hardly involved in this decision. Strangely, the oft-quoted rationale for the war was a remark by the tsarist minister of the interior, V. K. Plehve, in early 1904 before the disastrous Russo-Japanese war: "We need a small victorious war" (Gall and de Waal 1998). The first Chechnya war would prove as unsuccessful as the Russo-Japanese war. The "Party of War" thought the war would be popular because of Russians' dislike of Chechens, but they were mistaken. Only six years earlier, the Soviet Union had withdrawn from Afghanistan, and the Russian public opposed getting bogged down in another bloody quagmire in a mountainous, Muslim republic.

The Russian campaign was bungled from the beginning to the end. It was led by Minister of Defense Grachev, who promised an early and easy victory. Shortly before the invasion, Grachev boasted that "a battalion of paratroopers can take Grozny in two hours" (quoted in Klebnikov 2000, 42). But it took two months, because the Chechens unified and put up fierce resistance, while Grachev had deployed too few Russian troops, whose morale was deplorable. A horrendous bloodbath ensued. The Russian troops proved as incompetent as brutal. On the Chechen side, fundamental Islam was gaining popularity. The Chechens declared *jihād* (holy

war) on the Russian aggressors, committing atrocities that matched those of the Russian forces. The embarrassment for the Russian government was all the greater because Vladimir Gusinsky's TV network NTV showed the war in all its gruesome details, arousing public opposition.

In June 1995, a startling incident occurred. Chechen rebels, led by the radical Islamic commander Shamil Basaev, seized 1,500 hostages in a hospital in the town of Budyonovsk in southern Russia. Untypically, Chernomyrdin took charge and pursued telephone diplomacy with Basaev. Basaev and his guerilla troops were offered free passage to Chechnya, and the remaining hostages were saved, but about 120 people had already been killed. This was the first of several aggressive Chechen terrorist attacks in Russia proper (Klebnikov 2000, 43).

Meanwhile, substantial Russian troops had managed to gain control of most urban areas around Grozny, but not the mountainous regions of southern Chechnya, and Chechen warlords roamed at will. A few hundred Arab fighters led by veterans from the war in Afghanistan had joined the Chechens in their *jihād*. Up to 100,000 people, most of them civilian, are estimated to have been killed in this war. According to the official data, around 4,300 Russian soldiers were killed (Trenin and Malashenko 2004, 156).

The war in Chechnya was an unmitigated disaster, and the June 1996 presidential elections were approaching. Politically, the war harmed Yeltsin's popularity, while it strengthened the power of the secret police, military, and his *banya* team. The war in Chechnya undoubtedly undermined the future for Russia's democracy.

Halt of Reform Exacerbated Social Costs

Both in Russia and the West, the arrival of the regime of state enterprise managers was greeted with relief. At long last, the immature, irresponsible, and theoretical radical reformers were replaced with experienced, professional industrialists, such as Chernomyrdin and Soskovets, not to mention Gerashchenko, who were supposed to know how to build a market economy without the unnecessary social suffering characteristic of Gaidar's shock therapy. Yeltsin kept a low profile after the shootout at the White House, and the general impression was that he had fallen into a deep depression and tried to console himself with heavy drinking with his *banya* team.

The reality, however, was very different. Chernomyrdin, Soskovets, Zaveryukha, and Gerashchenko ignored the common good of Russian society, but they cared about their industrial lobbies, which they pampered with far more subsidies than the state could afford. The population, by contrast, did not benefit, although the worst hardships caused by the collapse of the old system had abated. Rather than proceeding with market

reforms, the Chernomyrdin government tried to halt the transition half-way, which maximized the social costs.

The rule of the state enterprise managers was accompanied by an unparalleled rise of organized crime, which was connected with the half-transformed economic system, in particular the aluminum war and the bankers' war. Law enforcement was widely considered to be complicit in organized crime, and the government did little to contain crime.

Yeltsin spent much of his time meeting Western and CIS leaders, but little came out of it. The most memorable interaction with the West was the 1995 financial stabilization program, which was based on standard IMF conditions and supported with substantial IMF credits. Yeltsin devoted considerable attention to the annual G-7 meetings, each year edging closer to full membership, but these overpublicized meetings resulted in nothing substantial. US President Bill Clinton liked Yeltsin and wanted to help him, but in Russia the window of opportunity had been closed, and Yeltsin did not deal with economic policy, so the United States could not do much. The West had missed its chance to promote economic reform in Russia, which would never come back.

Relations with the CIS countries posed a constant conundrum that remained the reserve of old Gosplan hands. The most important decision was the formation of a free trade area of all 12 CIS countries on April 15, 1994, but it was never quite implemented. In early 1994, Russia and Belarus agreed to form a union, designed to be a real federation, but it never evolved in spite of innumerable top-level meetings.

On January 20, 1995, Russia, Belarus, and Kazakhstan established a purported Customs Union, which never became even a free trade area. Later, Kyrgyzstan and Tajikistan acceded, but when it became obvious that the Customs Union was a sheer diversion its members renamed it the Eurasian Economic Community in 2000 (Michalopoulos and Tarr 1996, 1997; Olcott, Åslund, and Garnett 1999).

A large literature on Russia's economic reforms condemns the economic policy of this period for having been too radical, but that literature tends to be more emotional than factual.¹⁴ Chapter 3 showed how few and limited the radical reforms were in 1992, and in 1993 a number of catch-up reforms in deregulation and fiscal policy proved surprisingly effective. Over 1994 and 1995, Russia pursued no radical economic reforms whatsoever. The government contained no reformers with the exception of one single minister, Chubais. The economic results of this period were poor: The decline in output continued, officially totaling 17 percent in these two years (figure 4.1).

The only two significant acts of reform in 1994 and 1995 were spear-headed by Chubais. The first was the voucher privatization that was

14. Bogomolov (1996), Cohen (2000), Goldman (1996, 2003), Klein and Pomer (2001), Reddaway and Glinsky (2001), and Stiglitz (1999a, 2002).

successfully completed in 1994. By 1995, the EBRD (2000) assessed that 55 percent of Russia's GDP originated in the private sector, and Russia's privatization had become irreversible. Yet after the completion of mass privatization, it was politically difficult to proceed. The managers of the remaining big state enterprises refused to accept privatization for less than nearly complete ownership.

The other reform instigated by Chubais was the stabilization program adopted in March–April 1995 as a standby program with the IMF. This was Russia's first successful stabilization program, because it involved the first serious cut in the fiscal deficit since the beginning of the reforms in 1992. It had become possible thanks to an abatement of rent seeking, which had been prompted by the accumulated reforms in 1992 and 1993 as well as by attrition caused by rising market forces. Still, the fiscal adjustment was neither sufficient nor sustainable, because nothing had been done to the tax system or fiscal federalism.

On the whole, the policies of the government of state enterprise managers amounted to a massive failure. This was a period of larceny, organized crime, and irresponsibility, as the managers turned their back on all reforms. It was a low point in Russia's post-Soviet transition. Fortunately, so many of the pillars of a market economy had been installed in 1992–93 that a critical mass of market forces and private enterprise was about to emerge.

