

**Russia's Transfer From Communism to Capitalism: A Poor Economic Model and Its
Aftermath**

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Key Questions: Was the “shock therapy” economic model the best for a transitional Russia? Could another model have spurred the development of Russia into a powerful capitalist nation? How did the use of the “shock therapy” model affect the people and the fledgling democratic system in Russia?

Part I: Introduction, a Brief History, and Hypothesis

Throughout Russia's many centuries as a country (be it as the USSR or as a Tsardom), it only briefly flirted with capitalism before being plunged into the deep chasm that is the global capitalist economy in the early 1990's after the collapse of the Soviet Union and the formation of the Russian Federation. Though capitalism began developing in Russia in the last part of the 19th century and the early 20th century as a healthy alternative to the feudal society of the time, as Lenin describes in his paper, "The Development of Capitalism in Russia," it was a "still-born" economic system for Russia due to the lack of a foreign market (because of Russia's isolationist feudal policy at the time) (Lenin 1963: 44). Capitalism is completely demolished within Russia when Lenin and the Communist Party come into power in 1917. Lenin's anti-capitalist attitude can be seen in his later works: particularly in "Imperialism: The Highest Stage of Capitalism" where he describes capitalism as "parasitic and decaying" (Lenin 1963: 698). Capitalism remained stagnant in Russia until the 1980's, when Mikhail Gorbachev, then leader of the USSR, attempted to decentralize the government in what was intended to be a smooth, gradualist, transition into a democratic capitalist state (Gustafson 1999: 80). However, with a wave of nationalism and rebellion from the Russian outlying peripheries, Boris Yeltsin managed to stage a coup and take control of the government. It was at this point that Russia fell away from what could have been a stable socio-economic model of transition into what would prove to be a catastrophic failure. Yeltsin's swift breakup of the Soviet Union and radical economic policies resulted in an economic depression that some consider being worse than the Great Depression (Nolan 1995: 17-18). His use of the "shock therapy" economic transition model, a plan almost identical to that suggested and urged on by the IMF (George 1998:56), was inadequate for the Russia at the time and doomed to fail. This transition model, which supported rapid privatization and liberalization of national assets as well as a sudden "leap" into the foreign market, resulted in the meltdown of both the economy and the social and political order in Russia and the Eastern Bloc states.

As is clear by the condition of Russia, post-shock therapy, this decision by Boris Yeltsin and his economic (Western influenced) advisors was probably one of the worst approaches that the government could have taken in the economic transition from communism to capitalism. As such, in the following sections, the downfalls of the shock therapy model in Russia and its aftereffects (particularly the anthropological consequences) will be discussed, as well as alternative models that could have been used at the time: particularly the Neoclassical Gradualist Transition Model and the Chinese Economic Transition Model.

Part II: Analysis of the Shock Therapy Model In Russia

“Shock therapy advocates cite [Poland’s] successful economic performance as a vindication of the big bang [shock therapy] approach” (Hall and Elliott 1999: 305), it was this “admiration of the Polish reforms [that] was apparently an important ingredient in the calculus of the Russian reformers,” influenced heavily by the West, who suggested to Boris Yeltsin that he advocate this type of transition model despite protests from several Russian political economists as well as the previous reigning political group (Muller 1993: 112). In particular, Mikhail Gorbachev, the former reigning President states in one of his books that both the political and economic transition models used in Russia were not at all what he intended or what was best for the country, saying, “Instead of deepening reform in a gradual, evolutionary way – ‘shock therapy’ was the rule, along with the collapse of production and people’s living standards... All this taken together could no longer be called perestroika” (Gorbachev and Shriver 2000: 158). There are, however, many problems with comparing Poland to Russia.

First, in a country as large and disconnected from Western markets as Russia, such an economic model was doomed to fail. Even before the 20th century, Russia’s vast size meant that most of its economy was internally based. In fact, generally most of the trading that happened with Europe before then was a trading of the surplus and, as such, the Russian economy was not considered to be a part of the European periphery, but rather a separate entity (Wallerstein 2011: 307). The isolationist policies even then meant that Russia relied almost entirely on internal

production and trade, a trend that continued (though less and less throughout the 20th century) with the policies of the communist parties in charge thereafter. After decades of not having much outside trade interaction, a sudden plunge into the global economy, especially with a country as large as Russia was disastrous. Russia was not prepared to participate in a free market system as few people knew how to operate in a capitalist environment. Unlike the Russians, “the Poles had not lost practical knowledge of how to live and work in a free-market economy. (Klein 2001: 176). “Soviet authorities set about ridding themselves of all capitalist [law]... In effect the Soviets burnt their capitalist bridges behind them... While the Soviet purge of capitalist institutions was not entirely successful, it was successful enough so that any effort to reintroduce capitalism was bound to bring with it an enormous distortion as well as social and economic upheaval” (Lin and Song 2007: 185). Resultantly, with the rapid privatization of companies, there were few people in Russia who knew how to turn them into successful global capitalist enterprises. Small businesses suffered and the majority of Russia’s wealth fell into the hands of a fresh class of oligarchs at the top of a new clan capitalist system.

However, this was not only due to a general lack of knowledge by Russians on how to operate in a capitalist economy. The absence of regulation in the privatization of formerly public companies (which were nearly all lucrative government-owned natural resource acquisition companies) was mainly to blame for the creation of the clan capitalist system in a post-Soviet Russia. This is demonstrated by the fact that, despite the Russian GDP shrinking “by 40-50%” and 30% of the Russian population in 1998 “suddenly found themselves below the poverty line for the first time, seven Russians made it into the ranks of *Forbes Magazine*’s list of the world’s richest billionaires[, while prior] to 1991, there were none” (Lin and Song 2007:185). With the privatization of major companies such as the Ministry of Gas and the Ministry of Petroleum, the acting ministers and others who “had been members of the Soviet nomenklatura before the breakup of the country in 1991... simply seized for themselves some of the same properties they had managed for the state” at extremely discounted rates, bordering on thievery (Lin and Song

2007: 189). Not only this, but others connected to the state, such as the newly privatized banks from the Gorbachev era, created a new scheme called “Loans for Shares”. The owners of these banks created a system where they would hand out loans to the government in turn for extremely valuable companies, whose “ultimate proceeds for the state would substantially exceed the size of the loan” (Lin and Song 2007:190). Though, this would seem like a decent solution at the time considering Russia’s inability to pay back any loans it would take, “what was not as widely anticipated was that almost all the bankers would also rig their auctions” for the company shares.

Lin and Song describe this scheme in The Revival of Private Enterprise in China:

By disqualifying anyone who might make a serious competitive bid, the bankers conducting the auction made sure that they themselves would end up as the winners. In this way, Mikhail Khodorkovky was able to gain control of Yukos (a \$15 billion company) for some \$300 million. Similarly, Boris Berezovsky paid a mere hundred million dollars for what is now \$10 billion Sibneft. Potanin won control of Norilsk Nickel in the same way. (Lin and Song 2007: 190)

It is clear that the rapid, unregulated privatization of formerly public Russian companies, coupled with the unstable political situation at the time resulted in massive corruption which led to the creation of a new level of wealth among the oligarchs, while leaving many below the poverty line. Additionally, it left the government helpless in assisting those below the poverty line since the adjusted net national income fell from \$315.5987 billion in 1990 to \$147.8533 billion in 1995 (World Bank 2011).

Another major pitfall of the “shock therapy” model in Russia was the rapid release of prices (which were previously controlled by the Communist Regime). In January of 1992 Yeltsin’s reforms “freed 90% of retail prices overnight,” which almost immediately caused massive inflation (Gerber and Hout 1998: 4). In fact, “prices increased 1,100% during 1992,” and though “official records” said that wage prices kept up with this rapid price increase, economists such as Gerber and Hout seem to doubt this based on their own analysis of data and records (Gerber and Hout 1998: 4). They state how, “in November and December [of that year], food rationing was imposed in many parts of Russia” because prices were so high and stock was

so low (George 1998: 62). Gerber and Hout further describe the havoc that ensued because of this rapid increase in prices:

Cash shortages and the diminished real value of state subsidies led to the so-called “arrears crisis” of the summer of 1992, when some enterprises could not pay for goods delivered to them and suppliers could not meet their payrolls. Many enterprises found they could not pass the rising costs they were facing down the production chain. They had no alternative but to curtail output. The economy contracted. GDP declined by 18% in 1992, 12% in 1993, 15% in 1994, and 4% in 1995... By January 1996, the Russian economy was only three-fifths as large as it had been just four years earlier. Investments declined by almost half in 1992, by 12% in 1993, 23% in 1994, and 13% in 1995. Unemployment rose from almost zero at the end of 1991 to approximately 7% of the labor force by October 1995... Involuntary furloughs and delays in payments of wages and salaries also became endemic and remain so today. (Gerber and Hout 1998:5-6)

It is clear that such an overnight liberalization of prices was a poor decision on the part of the IMF in its suggestion of such a plan, and an even poorer decision to be implemented by Russian government figures and economists.

Lastly, a point that can be seen in the aforementioned arguments against the “shock therapy” model, Russia’s political situation was not stable enough to allow for such a rapid transition into the market economy. A more stable government which could keep track of the privatization of national assets, or that could aid small businesses in the transition from communism to capitalism would be able to make a “shock therapy” model work well. However, Russia’s feeble state after the breakup of the Soviet Union, lacking of a strong government (as well as a lack of foreign aid, promised by the West in return for implementing the IMF approved transition model) resulted in poor economic decisions and a free-for-all attitude in the liberalization of Russian prices and assets (George 1998: 60-61). Due to this, crime and corruption went rampant in clan capitalist economy which permeates through the entire former Soviet bloc still today.

Part III: The Anthropological and Political Effects of the Shock Therapy Model

It is distinctly because of the “shock therapy” transition model and a lack of proper implementation of transition methods in both the economy and the political government that resulted in over a decade of heavily decreased living conditions for an extremely large percentage of Russians (as well as many of the formerly Soviet states).

The people of Russia and the Soviet Bloc states were forced between 1991 (more pronouncedly 1992) and the 21st century to live in increasingly worse and worse living conditions. In a resurgence of organized crime (as well as random acts of violence), death rates increased from 10.7 people per thousand (1990) to 15.7 people per thousand (1994) and businessmen became frequent targets of contract killings (Shelley 1995: 1; World Bank 2011). Additionally to further show the effect of the sudden increase of violent crime on the lives of Russians in the 1990s: “From 1992 to 1994 life expectancy for Russian males dropped from 62.0 to 57.6 years and female life expectancy dropped from 73.8 years to 71.2 years” (Gavrilova 2000: 397).

Additionally, lower wages and higher prices resulted in massive shortages of food and an increased disability to afford living necessities (not to mention any commodities). “The average monthly wages per employee deflated by consumer price indices [and] calculated from reported annual data” (relative to percentages of the economy in 1989) fell from 100 in 1989 to 33 in 1993 and stayed as low until 2001 where it only reached back to 55 (United Nations 2004: 167). In fact, according to the United Nations, in 1998 in Russia, 50.3% of the population lived below the poverty line (\$4.30 PPP/day) and 18.8% of the population lived below the extreme poverty line (\$2.15 PPP/day). In some other formerly Soviet countries, the numbers are more terrifying, such as in Moldova where 55.4% of the population in 1999 lived below the extreme poverty line and in Tajikistan where 68.3% of the population lived below the extreme poverty line (United Nations 2004: 169). As mentioned previously, the result of this came in the form of a need for food rationing and an inability to provide for families which then resulted in a turn to violence and a decrease in life expectancy (Gavrilova 200: 399).

However, despite the majority of the population living below, or close to, the poverty line, Russia for the first time in its history, as mentioned earlier, managed to produce dozens of billionaires controlling the majority of the country’s wealth. To further show how vast the gap between rich and poor grew, the GINI index grew from 23.8 in 1988 to 43.38 in 1993 (World

Bank 2011). This brings about the topic of corruption in Russian society following the collapse of the Soviet Union.

In addition to the corruption within the government discussed earlier (with the rapid privatization of national companies), the “shock therapy” economic model and the collapse of the economic system that followed bred a new generation of corrupt government officials rivaling that of any previous time in Russia’s history. To this day, new scandals of corruption and shady movements by government officials happen on a nearly daily basis (such as the recent 2012 Duma elections, in which evidence was found that Vladimir Putin’s party had participated in election-rigging, among many other cases). James Roaf of the IMF describes the corruption in Russia more quantitatively:

Russia consistently ranks poorly in international comparisons of corruption. For example, probably the most widely quoted source, the Transparency International (TI) survey, placed Russia 82nd out of 99 countries in 1999, with a score of 2.4 on a scale of 0 (highly corrupt) to 10 (highly clean). An aggregate indicator of graft compiled from numerous sources by Kaufmann et al. (1999a) places Russia 113th out of 155 countries. In a 1997 survey conducted by the Economist Intelligence Unit, the CIS emerged as markedly more corrupt than any other region of the world, with Russia (along with the other four CIS countries included in the survey) receiving the maximum rating for corruption among public officials... As to the scale of corruption in absolute monetary terms, this is very difficult to gauge. The 1999 EBRD/World Bank survey reported that Russian firms paid an average of 4.1 percent of annual revenues in bribes, somewhat less than the CIS average of 5.7 percent.

Roaf later describes the reasons for corruption initially as a need to add to the low government wages in the early and mid-1990’s. However, he also describes how, though these needs began to disappear toward the 21st century, a culture had been built based on corruption and bribery due to the economic problems resulting from the “shock therapy” model. Currently in 2012, Russia still has a 2.4 corruption rating according to the TI survey (Corruption perception index 2012), showing that this culture of corruption has not died down in the slightest.

It is clear by looking at the state of the Russian government, as well as examining the conditions in which the Russian people lived in after, that the chosen transition model (into both capitalism and “democracy”) was a terrible mistake that instated a corrupt and resulted in the quick decline of living and social conditions. An alternative model could have prevented this.

Part IV: Alternatives to the Shock Therapy Model

Due to the decision to use the shock therapy model, now, “critics cite [Russia’s] economic quagmire as proof that a more gradual economic transformation would have been preferable” (Hall and Elliott 1999: 305). There are two gradualist models that should be particularly considered when analysing what could have been used in place of the shock therapy model in Russia during the 1990’s: the Neoclassical gradualist model and the Chinese model.

The Chinese Model wasn’t so much an economic model when it began its formation, but rather it was a collection of “minimally controversial yet productive reforms based on small indigenous experiments gradually modified and expanded to fit the circumstances” (Johnson 1994: 61). The Chinese model is particularly appealing due to its major success. Since its implementation, “China’s GNP has grown by an average of close to 9 per cent a year... and in 1992 its economy grew by a remarkable 12 per cent... Foreign investment has increased dramatically and competitive market has been established, but without a drop in social services” (Johnson 1994: 60). The similar situations in Russia and China before the time of transition make the Chinese model seem significantly more appealing than any other model, especially because of the success of the Chinese economy in becoming a world frontrunner. However, there are several major differences which make this model inapplicable to Russia’s situation after the collapse of the Soviet Union. First, Russia simply did not have the foreign investment interest, nor a “wealthy expatriate community” as China did. China was able to make many of the reforms with investment from “ethnic Chinese entrepreneurs living in prosperous Taiwan and Hong Kong” (Johnson 1994: 70). Russia had no such investment and even greater costs due to a vast social protection net. More importantly, China was not transitioning government systems at the same time as economic systems as Russia was, Russia did not have the political strength to enforce while it was still transitioning its government system, resulting in the ruling out of the Chinese Model for a transitioning Russia in the 1990’s.

The “fundamental basis of the neoclassical gradualist approach to transition [is] to establish economic, institutional, political and ideological structures before any attempt at

liberalization” (Marangos 2005: 264). This would have been particularly applicable to the case of a transitional Russia, as the problems stemming from the rapid liberalization came mainly from the lack of a stable base structure before doing so. The neoclassical model makes sure that a solid government base is founded before economic transition is attempted. John Marangos rates the Neoclassical as the optimum transition model for several reasons. He states that the “reduction in output was smaller than under shock therapy; political support for the reform was maintained after the election results; foreign aid was provided, albeit less than in the shock therapy model; and foreign direct investment was substantial due to auctioning of the state enterprises, in contrast to the free distribution of shares by the shock therapy model” (Marangos 1994: 244).

The neoclassical gradualist approach addresses all the problems of the shock therapy model and even some problems stemming from its own use. First, though international aid would lessen because the IMF and World Bank give more aid to countries using the Shock Therapy model of transition, the neoclassical gradualist model addresses this due to the longevity of the reforms. The slower transition process, the stable political base established before transition, and the use of “special economic zones” all allow for the government to accomplish the transition without as much foreign aid and investment (Marangos 1994: 242). Additionally, the rapid inflation and wage gaps caused by the shock therapy model would not occur because of the slower transition process. The newly stabilized government could slowly remove controls and gradually liberalize assets, keeping wages relatively similar and price inflation at bay. It is for these reasons among others that make the Neoclassical Gradualist model a more ideal approach to the Russian transition to capitalism in the late 20th century.

Part V: Conclusion

As has been presented, it is clear that the socio-economic condition of the Eastern Bloc states, in particular in Russia, was severely degraded by the use of the shock therapy model. The poverty, corruption, and crime that plague these nations today are a direct result of the use of this

model. The IMF's persistent pushing of the use of this economic model (in part due to the Reagan and Thatcher administrations threatening not to give aid with the use of any other model) and the poor political situation in a post-Soviet Union Russia was mostly the cause of the implementation of shock therapy in the Soviet Bloc (George 1998). The rapid liberalization of Russian assets and almost overnight release of price controls, as per the shock therapy model, resulted in a poverty level that even in the 21st century has not been able to reach Soviet conditions (United Nations 2004: 167).

It is clear that a better alternative to the shock therapy model would have been a gradualist approach. Due to the political situation in Russia at the time, a neoclassical gradualist approach would have been particularly more effective because of the establishment of a strong political and economic base before the implementation capitalist reform. This would have undoubtedly kept Russia as a major world power perhaps in a similar fashion to the Chinese government and economy. In fact perhaps a patriarchal capitalist system as in China would have been beneficial in the transition phase for Russia, to then later be reformed to a more democratic system, but there is no way of knowing whether this would have been successful or not.

Today, though Russia is slowly regaining its former power and position in the world order, the economy still ails and there is still massive widespread corruption in the government and business sectors. The solutions to these problems and the path to recovery from the shock therapy model are unclear. Though the Medvedev administration in 2008 attempted to instantiate anti-corruption laws, since then Russia's corruption index has actually gotten worse dropping to 154th out of 178 countries in 2010 (Corruption perception index 2010). Similar economic reforms have been implemented as well, but to no avail. Russia still struggles to compete on the global market and in the meantime fights with poverty, corruption, a heavily declining population, drug abuse, and a loss of culture to globalism. Though it is clear that something must be done about Russia's current socio-political-economic situation, solutions seem to defy both the Russian government and foreign analysts.

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