

PROPERTY RELATIONS  
FROM THE USSR TO THE RUSSIAN FEDERATION:  
CONTINUITY OR CHANGE?

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SERAP ATALAY

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Approval of the Graduate School of Social Sciences

---

Prof. Dr. Sencer AYATA  
Director

I certify that this thesis satisfies all the requirements as a thesis for the degree of Master of Science of International Relations.

---

Prof. Dr. Atilla ERALP  
Head of Department

This is to certify that we have read this thesis and that in our opinion it is fully adequate, in scope and quality, as a thesis for the degree of Master of Science of International Relations.

---

Assist. Prof. Dr. Pınar BEDİRHANOĞLU  
Supervisor

**Examining Committee Members**

Assoc. Prof. Dr. Pınar AKÇALI	(METU, ADM)	_____
Assist. Prof. Dr. Pınar BEDİRHANOĞLU	(METU, IR)	_____
Assist. Prof. Dr. Ayşegül KİBAROĞLU	(METU, IR)	_____

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Name, Last name: Serap ATALAY

Signature :

## **ABSTRACT**

### **PROPERTY RELATIONS FROM THE USSR TO THE RUSSIAN FEDERATION: CONTINUITY OR CHANGE?**

ATALAY, Serap

M.Sc., Department of International Relations

Supervisor: Assist. Prof. Dr. Pınar BEDİRHANOĞLU

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This study, by focusing on the economic reform attempts in the USSR and the privatization process in the Russian Federation, will question the scope of political change in Russia during the capitalist transformation process until the end of the Yeltsin period. It will be argued that the determination of the political processes on property relations during the time of the USSR persisted in the Yeltsin period since after the collapse of the USSR, main political actors of the Soviet system such as the Party and ministry officials and the enterprise managers maintained their dominant positions within the property relations. As will be shown in the thesis, this was ensured through their successful interventions in the privatization processes. Hence, people who had important positions in the former Soviet Union, became whether the new owners of state assets, or had the authority to determine the new owners.

Keywords: Property Relations, Russia, USSR, Privatization

## ÖZ

### SSCB'DEN RUSYA FEDERASYONUNA MÜLKİYET İLİŞKİLERİ: DEVAMLILIK MI, DEĞİŞİM Mİ?

ATALAY, SERAP

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Bu çalışma, Yeltsin döneminin sonuna kadarki süreç içinde kapitalist dönüşüm sürecinde Rusya'da yaşanan politik değişimin kapsamını, SSCB'deki ekonomik reformlar ve Rusya Federasyonu'ndaki özelleştirme sürecine odaklanarak inceleyecektir. SSCB döneminde mülkiyet ilişkileri üzerindeki politik sürecin belirleyiciliği SSCB yıkıldıktan sonra Yeltsin döneminde de devam etti, Parti ve bakanlık yetkilileri ve işletme müdürleri gibi Sovyet sisteminin başlıca politik aktörleri mülkiyet ilişkileri bakımından baskın konumlarını sürdürdüler. Tezde görüleceği gibi, bu onların özelleştirme sürecine yaptıkları başarılı müdahaleleri yoluyla sağlandı. Böylece, eski Sovyetler Birliği'nde önemli konumlara sahip olan kimseler, ya devlet mallarının yeni sahibi oldular ya da yeni sahipleri belirleme yetkisine sahip oldular.

Anahtar Kelimeler: Mülkiyet İlişkileri, Rusya, SSCB, Özelleştirme

To My Lover

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## LIST OF ABBREVIATIONS

CPSU	Communist Party of the Soviet Union
FIGs	Financial-Industrial Groups
FSC	Federal Stock Corporation
GKI	State Property Committee
GKNT	Science and Technology Committee
Glasnost	Openness policy in Gorbachev era
Glavki	Sub-divisions of Ministries
Gosbank	The State Bank
Goskomsent	Prices Committee
Gosplan	State Planning Commission
Gossnab	Materials And Equipment Supply Committee
IMF	International Monetary Fund
JSC	Joint Stock Company
Knozaschet	Economic Accounting
Kolkhoz	Cooperative
NEP	New Economic Policy
NNO	Normative Net Output
Nomenklatura	A group of people who took part in the administrative bodies of the Soviet Union.
NPOs	Scientific Production Associations
NTV	The Independent Television
OECD	Organization for Economic Cooperation and Development
ORT	Russian Public Television
Perestroika	Restructuring policy in Gorbachev era
Piatiletkas	Five-Year Plans in the Soviet Union
Politburo	The Highest Lawmaking Body of the Communist Party
Presidium	The main executive body of the Supreme Soviet
RFFP	Russian Fund of the Federal Property
RPC	Russian Privatization Center

RSFSR	Russian Soviet Federal Socialist Republic
SDR	Special Drawing Rights
Semibankirshchina	The oligarchic rule of the seven bankers
Sovnarkhoz	Regional Economic Councils
USA	United States Of America
Uskorenie	Acceleration policy in Gorbachev era
USSR	Union Of Soviet Socialist Republics
VIF	Voucher Investment Fund
VPOs	All Union Industrial Associations
VSNKh	Supreme Economic Council



## CHAPTER 1

### INTRODUCTION

The collapse of the Soviet Union in 1991 is one of the most important events of the 20<sup>th</sup> century. Many writers, especially the liberal ones, considered this development as the proof of the victory of capitalism against socialism in line with their worldviews.

It has to be reminded that this sense of victory of the early 1990s left its place into a cautious stand as it became clear in the former Soviet Union countries, specifically in Russia, that market economy could not fulfill the expectations attributed to it. Corruption, crises and poverty, as leading issues, have started to dominate the books and articles on “transition”. Since then, one of the most important arguments, used by many writers to explain the reasons of such an outcome, has been that the political power could not really be transformed in Russia after the collapse of the Union of Soviet Socialist Republics (USSR). It has been stressed that the former *nomenklatura* in the USSR has maintained their ruling position in the new system as the new capitalist class.

Nomenklatura can be defined as a group of people who took part in the administrative bodies of the Soviet Union. They received a whole range of hidden privileges which were not available to the rest of the population due to their loyalty to the Communist Party of the Soviet Union (CPSU). This group consisted of people who had high responsibility positions, from top to bottom, such as, the members of central bodies of the CPSU, the members of the council of ministries, managers of state enterprises etc.

This study agrees with such comments and, aims to support them by examining closely the economic reform attempts in the USSR and the privatization process in the Russian Federation in order to show how *nomenklatura* has managed this. It will be argued that the dominance of the political processes on property relations during the time of the USSR persisted

in the Yeltsin period as after the collapse of the USSR, main political actors of the Soviet system such as the Party and ministry officials and the enterprise managers maintained their dominant positions within the property relations. As will be shown in the thesis, this was ensured through their successful interventions in the privatization processes. Hence, people who had important positions in the former Soviet Union, became whether the new owners of state assets, or had the authority to determine the new owners.

As the main steps to transfer the ownership of assets to private hands were largely taken during the Yeltsin period, the thesis aims to examine the process of change in property relations until the end of the Yeltsin period. The succeeding Putin period has been deliberately excluded from the scope of this thesis as it requires a detailed analysis of its own as a presently debated issue.

In order to show how property relations persisted in fundamental ways during the transition from Soviet socialism to Russian capitalism, both periods have to be examined by focusing on this question. The thesis hence gives equal weight to the USSR and Russian developments in terms of changes or continuities in property relations. While chapters 2 and 3 deal with the basic features of the Soviet property relations as well as attempts for reform in this sense covering the most ambitious Gorbachev period, chapters 4 and 5 cover different forms of privatization processes during the Yeltsin era.

Soviet Union was based on a command economy, and private property did not exist, so the reform attempts in the Soviet Union since the 1960s were principally related to changes in production relations, rather than the transfer of the property rights. Soviet production relations differed from property relations in capitalist system. The subjects of property rights were government officials and the mechanisms and tools of the transfer of the property rights were through delivery and distribution in the Soviet structure. The division of property into categories and hierarchies in the Soviet system was based on political rather than economic considerations. These issues will be examined in detail in the second chapter of the thesis by overviewing the political structure of the USSR, the planning process as well as the deficiencies of the system and

persistent attempts to reform it through further centralization and/or decentralization.

In the third chapter, the strong position of the Soviet *nomenklatura* over the state assets and its resistance to reform attempts concerning the production relations in the Soviet system will be examined during the Gorbachev period. This period has a crucial importance in Soviet history because Soviet Union entered in this period to the irreversible road to capitalism. The chapter will try to discuss some possible reasons of this radical change by concentrating on the struggles on reform.

With the fourth chapter, the thesis will start examining the Yeltsin period, and mass privatizations between 1992 and 1994 will be its first focus in this sense. Mass privatizations, as will be argued, was one of the greatest and fastest examples of its sort in the world, but it could not substantially change the property relations Russia has inherited from the USSR. The implementation of the mass privatizations program was not competitive and open to foreign investors. Instead, they were uncompetitive and restricted to foreign investors. Former *nomenklatura* played a major role in the transformation of production relations from state control to private ownership and realized this change in the form of maintaining its power on distribution of ownership through several political collaborations. Namely, former Soviet *nomenklatura* transformed itself into a capitalist dominating class in the Russian Federation.

In the fifth chapter, the next rounds of the privatization process in Russia will be examined: namely cash privatizations and shares for loan privatizations. The Russian government launched these privatization programs to find a solution to its budget deficit problem though they ended up by transferring the country's most lucrative assets to corrupt private hands, later to be defined as "oligarchs". Under these privatization schemes, leading firms of the Russian economy, such as oil and gas firms, were sold off to "selected individuals" despite the opposition of the Russian Parliament. This chapter will try to show that Russia's capitalist class today

has acquired this position through a very corrupt process that benefited a lot from the inherited power relations from the USSR.

## CHAPTER 2

### THE SOVIET SYSTEM AND REFORM ATTEMPTS

#### 2.1 Introduction

This chapter will examine the general features of the Soviet system and the reform attempts until the Gorbachev period. After a brief explanation on the constitutional structure of the Soviet system in terms of its executive and legislative bodies, the role of the CPSU and the Supreme Economic Council (*Vysshiy Sovet Narodnogo Khoziajstva, VSNKh*) will be analyzed in order to exhibit some distinctive features of the Soviet state. Then, the characteristics as well as the deficiencies of the planning process and property relations in the USSR will be briefly discussed before a comprehensive analysis of the reform attempts since the early years of the Soviet Union until the Gorbachev period will be examined in a chronological order.

As discussed in the chapter, although some systemic problems of the Soviet system such as huge bureaucracy, poor quality of goods, shortages of consumer goods and lack of incentive had necessitated substantial reforms, the Soviet *nomenklatura* displayed a firm resistance to such efforts as it perceived them as threat to its authority over the state assets. Many reform attempts were either hindered or made ineffective during their implementation.

Understanding the strong authority of the *nomenklatura* over the Soviet system is important as this would enable one to grasp why different privatization programs during the transition process later did all serve ultimately to the interests of the former Soviet *nomenklatura* at large and helped them transform themselves into the new bourgeoisie of the Russian capitalism.

## **2.2 General Features of the Soviet System**

### **2.2.1 Constitutional Structure of the Soviet System**

Following the revolution of 1917, the founders of Soviet Union, Vladimir I. Lenin and his successor Stalin tried to form a socialist system. In theory, the Communist party came to power and intended the creation of a revolutionary democracy. According to Lenin's vision of revolutionary democracy the state with its bureaucracies, paramilitary arms, ministries, and government would eventually disappear. However, in practice, this vision was not realized and the Soviet system turned more complex day by day in terms of its structure and legality. A huge bureaucracy that had been developed in this process became the main hindrance for many of the important reform initiatives, while attempted reforms served ironically to the further strengthening of the bureaucratic structure.

#### **2.2.1.1 Legislation**

As an indicator of the theoretically democratic structure, the Soviets functioned at all levels of the system as both popularly elected legislative assemblies and as organs of the government. All Soviets were directly elected. The people's deputies (members of Soviets) were subject to recall. At the same time, all Soviets combined legislative and executive functions to a certain degree.<sup>1</sup>

The USSR Supreme Soviet was the 'highest body of the state authority' and the supreme legislative body. It had two chambers: the Soviet of the Union which was directly elected by the Soviet population as a whole; and the Soviet of Nationalities elected proportionately by the USSR's many nations.<sup>2</sup> In principle, it was responsible for; (a) making all laws in areas of federal jurisdiction, (b) appointing the ministers of the government and overseeing the

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<sup>1</sup> Rachel Walker, *Six Years that Shook the World, Perestroika-The Impossible Project*, Manchester and New York, Manchester University Press, 1993, p. 23.

<sup>2</sup> Robert Beard, "1936 Constitution of the USSR,"  
<<http://www.departments.bucknell.edu/russian/const/1936toc.html>>

activities of the government, (c) ratifying the decisions of the republican Supreme Soviets below it.<sup>3</sup> USSR Supreme Soviet *Presidium* was executing the promotion and dismissal of government ministers, declaration of states of emergency, and ratification of treaties as the main executive body of the Supreme Soviet.<sup>4</sup>

In addition to these central legislative bodies, each of the USSR's fifteen Union-republics had their own Supreme Soviet, elected by the population of the republic. Also, at the regional, city, and district levels, local Soviets were directly elected by their populations. Although local soviets were supposed to have considerable powers to control the activities of local industry and agriculture, their roles in practice remained largely limited with the supply of local services such as education, health, municipal lightings, etc.

The hierarchy of the Soviets was like a pyramid, with the USSR Supreme Soviet at the pinnacle, and the numerous districts Soviets forming its base. Power effectively flowed from the top to bottom.

#### **2.2.1.2 Execution**

The Councils of Ministers were the highest administrative and executive bodies of state authority.<sup>5</sup> They also existed at the all-Union, Union-republican and autonomous republican levels. At the Union level, the USSR Council of Ministers had executive responsibility for the administration and management of the Soviet economy and social affairs. Its members were the ministerial heads of the big all-Union ministries which operated across the Soviet territory or the heads of several State Committees. Ministers were supposed to be nominated by the USSR Supreme Soviet and they were supposed to account regularly to USSR Supreme Soviet deputies for their activities.

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<sup>3</sup> *Ibid.*, p. 24.

<sup>4</sup> Robert Beard, "1936 Constitution of the USSR," <http://www.departments.bucknell.edu/russian/const/1936toc.html>

<sup>5</sup> *Ibid.*, p. 25.

The Republican Councils of Ministers were assumed to have independent executive authority on their territory to run the economy of their Union or autonomous republic. At the same time, the Republican Councils of Ministers could call off the decisions of the executive committees of the Soviets at the regional level and below, because the Soviets, in addition to their legislative functions, were also supposed to have considerable responsibility for the local economy.<sup>6</sup>

The main aim of this system was that it was supposed to guarantee the democratic participation of the whole population in the management of societal affairs. Although this system did include a great deal of participation, it was often rather formal. Ironically, there were over two million deputies involved in the activities of the Soviets and in any period of ten years about five million people, a notably high proportion of the population, would have experienced deputy service.<sup>7</sup>

Hence, the executive arm of the state was also shaped like a pyramid, with the USSR Council of Ministers at the pinnacle overseeing an enormous network of all-union ministries, followed by the Union-Republican Councils of Ministers, the Councils of Ministers of the autonomous republics, and the executive committees of all the local soviets in a downward hierarchy of power.

### **2.2.1.3 The CPSU**

The role and position of the CPSU in the Soviet system had always been important. The responsibility of the ruling Communist Party was the creation and management of policies and the maintenance of centralized control over the system. The party was set up on a hierarchical pattern enabling a stress on top-down decision making from its inner cabinet, through the Central Committee and its Secretariat, down to party offices and delegates in all areas of social and economic life. At the same time the party was integrated

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<sup>6</sup> *Ibid.*, p. 26.

<sup>7</sup> *Ibid.*, p. 27.



with the structure of the state in such a way that all major social and political organizations were officially incorporated under its general supervision.<sup>8</sup> It supervised recruitment to all positions of influence and responsibility in government ministries and throughout the Soviet system and finally oversaw the implementation of policies at all levels.<sup>9</sup>

#### **2.2.1.4 The VSNKh**

*VSNKh* was another important body in the Soviet system. After Lenin came to power on December 15, 1917, the new Soviet government formed it to completely reorganize the national economy. The nationalization of enterprises soon commenced, and responding to the spread of unauthorized nationalization initiatives conducted by local authorities, the *VSNKh* in January 1918 decreed that no nationalization should be carried out without its clear approval. By May, thirty eight provincial and sixty-nine district regional councils had been set up to administer the economy under the supervision of the *VSNKh*. By September 1919, *VSNKh* had obtained control of 1.300 enterprises employing about 1.3 million people. A year later 80 percent of industrial enterprises had been nationalized. Thousands of small enterprises were also nationalized during this period.<sup>10</sup> But the results were not good as industrial production declined to one-fifth of the prewar level, and real income per capita dropped by 60 percent.<sup>11</sup>

#### **2.2.2 Planning Process**

The economy of the Soviet Union was based on a system of state ownership and administrative planning, and the planning process was another important feature of the Soviet system. The defects of the planning process,

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<sup>8</sup> Terry Cox, *From Perestroika to Privatization*, Brookfield, USA, Aldershot, 1996, p. 7.

<sup>9</sup> *Ibid*, p. 7.

<sup>10</sup> Lynn D. Nelson, Irina Y. Kuzes, *Radical Reforms in Yeltsin's Russia: Political, Economic and Social Dimensions*, London, M.E. Sharpe, 1995, p. 6.

<sup>11</sup> Jonathan Been, "Nikolai Bukharin and the New Economic Policy A Middle Way?," *The Independent Review*, Vol. II, No.1, Summer 1997, pp. 79-95, p. 80.

which will be taken up at the second part of this chapter, were the main inspiration behind the reform attempts.

Stalin introduced planning in late 1920s as the fastest means to achieve industrial development and economic growth.<sup>12</sup> After 1928, the entire course of the economy was guided by series of ambitious five-year plans (*Piatiletkas*). Under Stalin's instruction, a complex system of planning arrangements had developed. The five-year plans integrated short-range planning into a longer time slice. They described the chief push of the country's economic development and specified the way the economy could meet the desired aims of the Communist Party. Although the five-year plans were enacted into law, they contained series of guidelines rather than sets of direct orders.

Periods covered by the five-year plans took up the same place with those covered by the meetings of the CPSU Party Congress. At each CPSU Congress, the party leadership presented the goals for the next five-year plan. Thus, each plan had the approval of the most authoritative body of the country's leading political institution.

The Central Committee of the CPSU and, more specifically, its Politburo, set the basic rules for planning. The Politburo determined the general direction of the economy by means of control figures, major investment projects, and general economic policies. These guidelines were submitted as a report of the Central Committee to the Congress of the CPSU to be approved there. Following the approval of the Congress, the Council of Ministers set the priorities of the five-year plan and sent them to *Gosplan*<sup>13</sup> for their fulfillment and supervision.<sup>14</sup>

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<sup>12</sup> Walker, *op. cit.* p. 27.

<sup>13</sup> Among more than twenty state committees, *Gosplan* headed the government's planning apparatus and was by far the most important agency in the economic administration. The Soviet economy was managed through *Gosplan* (the State Planning Commission), *Gosbank* (the State Bank) and the *Gosstab* (State Commission for Materials and Equipment Supply). The state planning agency was subdivided into its own industrial departments, such as coal, iron, and machine building. It also had other departments such as finance, dealing with issues that crossed functional boundaries. With the exception of a brief experiment with regional planning during the Khrushchev era in the 1950s, the Soviet planning was done on a sectoral

Economic ministries also played key roles in the Soviet organizational structure. When the planning goals were established by *Gosplan*, economic ministries drafted plans within their jurisdictions and spread planning data to the inferior enterprises. Hence, the planning data were sent down through the planning hierarchy for progressively more detailed elaboration.

The Soviet enterprises produced not according to the market incentives but according to the plan.<sup>15</sup> Enterprises were called upon to develop the most detailed plans covering all aspects of their operations so that they could assess the feasibility of targets.<sup>16</sup> The plan targets were raised on the basis of past performance, with little regard for productive potentials. The enterprises had no regard for costs, for which they were not responsible. The strength and prosperity of the enterprises depended not on their productivity but on their ability to negotiate a favorable plan with the Ministry. The planning system was changed into a bargaining between the Ministry and the enterprises. At the same time, it can be said that, it was precisely the 'assessment according to the Plan' (i.e., payment of incentives according to the fulfillment or over-fulfillment of targets determined in the Plan to) that caused enterprises to try to distort economic information to understate their capacity and overstate their applications for resources, which would allow them to fulfill targets more easily and acquire material advantages if they fulfilled a taut plan.

As the individual enterprise drafted its detailed production plans, the flow of information was reversed; enterprise managers often participated in the planning process at this level. The enterprises' draft plans were then sent back up through the

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basis rather than on a regional basis. <http://www.answers.com/topic/economy-of-the-soviet-union>

<sup>14</sup> "Economy of the Soviet Union," Wikipedia, 2005, April 5, 2005.  
<http://www.answers.com/topic/economy-of-the-soviet-union>

<sup>15</sup> Walker, *op. cit.*, p. 27.

<sup>16</sup> "Economy of the Soviet Union," Wikipedia, 2005, April 5, 2005.  
<http://www.answers.com/topic/economy-of-the-soviet-union>

planning ministries for review. This process entailed intensive bargaining, with all parties seeking the target levels and input figures that best suited their interests.<sup>17</sup>

After this bargaining process, *Gosplan* received the revised estimates and re-aggregated them as it saw appropriate. Then, the re-drafted plan was sent to the Council of Ministers, the Politburo, and Central Committee Secretariat for approval. The Council of Ministers submitted the Plan to the Supreme Soviet and the Central Committee submitted the Plan to the Party Congress, both for approval. By then, the process had been completed and the plan became law.

The review, revision, and approval of the five-year plans were followed by another downward flow of information, this time with the amended and final plans including the specific targets for each sector of the economy. At this point, implementation which was largely under the control of the enterprise managers started.

### **2.2.3 Property Relations in the USSR**

#### **2.2.3.1 Traditional Russian Property Relations**

Russian economic mentality was based on the monopolization of official functions in a public division of labor, and power and domination were based not on private property but on high status in traditional hierarchy and prestige.<sup>18</sup>

The well-being of a representative of a ruling class absolutely depended on his place in state hierarchy. There was no reliable guarantee of property in Russian society and the officials' privileges were guaranteed by only their

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<sup>17</sup> "Economy of the Soviet Union," Wikipedia, 2005, April 5, 2005.  
<http://www.answers.com/topic/economy-of-the-soviet-union>

<sup>18</sup> Rustem Nureev, Anton Runov, "Russia: Whether Deprivatization is Inevitable? Power-Property Phenomenon as a Path Dependence Problem," Prepared for International Society for New Institutional Economics-2001 5-th Annual Conference "*Institutions and Governance*" USA, Berkeley, California, September 13-15, 2001, pp. 1-41, p. 5.

posts in the bureaucracy. The representatives of state power had direct and indirect incomes because of their official functions.

Nureev and Runov argue that:

Russian culture related to economic mentality can be characterized as municipal, communal, considering the man as the part of whole. Processes of reciprocity and redistribution always played an important role in Russia. It developed propensity to humility and resignation and interfered with allocation of the individual as independent agent, absolutizing moral values in contrasting material values. Property was frequently considered in Russian culture as negative thing. Freedom was treated not as independence, but as an opportunity to do what you like (in spirit of anarchy and willfulness). The dependence of the individuals on a community prevented the development of private work and private property, increase of efficiency and culture of individual production.<sup>19</sup>

### **2.2.3.2 The Soviet Property System**

#### **2.2.3.2.1 Property System in Law and Marxist Theory**

The process of the establishment of the public property system started in 1932 by a decree of the Council of People's Commissariats, which proclaimed that public property is the base of the Soviet social order. Violation of the decree was decided to be sentenced as death penalty and by the beginning of 1933, according to official statistics, 54.645 persons had been convicted under the new law, 2110 of whom had been shot.<sup>20</sup>

The Stalin Constitution was adopted in 1936. This Constitution was a watershed in the politization of property. This constitution declared that socialist ownership of the means of production was the economic base of the USSR. [Article 4]. Socialist property was “the source of the wealth and strength of the motherland” and the “sacred and inalienable foundation of the

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<sup>19</sup> *Ibid.* p. 6.

<sup>20</sup> Kevin P. Block, “Depolitizing Ownership an Examination of the Property Reform Debate and the Law on Ownership in the USSR,” *Berkeley-Duke Occasional Papers on the Second Economy in The USSR*, p. 3.

Soviet social order” [Article 131]. Those who undermined socialist property were the “enemies of the people” [Article 131].<sup>21</sup>

The 1936 Constitution brought two important conceptual changes concerning ownership. It classified property into socialist and non-socialist varieties. Property owned by the state was socialist, and contained the land, air, water and means of production [Article 5-6]. Cooperative (*kolkhoz*) property too was supposed as socialist [Article 5]. Property owned by individual citizens on the other hand was regarded to be not socialist but “individual” property, and was limited to a residence and items for every day use [Article 10].<sup>22</sup>

In addition, this constitution set up a hierarchy of property with state ownership (for example state farms, *soukhoz*), which belonged to all people, ranking at the top. Secondly, collective property (for example collective farms, *kolkhozes*) was another category in the hierarchy of property. In this category, the land was owned by the state, but the activities of the collective farms were controlled by the collective farmers. The farmers owned and run the collective farms as cooperatives.<sup>23</sup> Lastly, individual property contained individual’s savings residence household goods and other items of every day use.<sup>24</sup>

According to Marxist doctrine, ownership is traditionally viewed as the key to political power.<sup>25</sup> The division of property into categories and hierarchies in the Soviet system was based on political rather than economic considerations. In the Stalin era, ownership as an economic term disappeared from the professional literature, and was replaced by the identification of ownership with political power. For example, ownership had been defined as a manifestation of class struggle in this era.<sup>26</sup>

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<sup>21</sup> *Ibid.*

<sup>22</sup> *Ibid.*

<sup>23</sup> Walker, *op cit.*, p. 47.

<sup>24</sup> Block, *op cit.*, p. 3.

<sup>25</sup> *Ibid.* p. 2.

<sup>26</sup> *Ibid.* p. 3.

In order to understand the Soviet property system, a comparative analysis with private property system can be useful as did Nureev and Runov.<sup>27</sup> One of the important differences is that, public-service property exists in the Soviet property system while private property exists in private property system. The subjects of property rights are government officials in the Soviet property system whereas individual owners exist in private property system. Types of property rights concerned in the Soviet property system are public-service rights of officials within the framework of the hierarchical system of state management, and individual rights in private property system. When it comes to the question of rights and responsibilities; while they are distributed between all managing subjects but not belonging entirely to anybody in the Soviet property system, the separate bunches of rights and responsibilities belong to independent private proprietors. Target function of subjects is the maximization of difference between received distributions and deliveries in the Soviet property system; while it is the maximization of given current cost of actives or dividends under the shares in the enterprise in private property system. In the Soviet property system administrative control provides the motivation, on the other hand individuals provide motivation to increase personal well-being in private property system. Delivery and distribution are the mechanisms and tools of the transfer of the property rights in the Soviet property system, while they are the contracts between the independent participants in private property system. In the Soviet system the guarantees of property rights are special administrative retaliatory divisions of central or regional power. In contrast to this, in the western private property style, there are courts, law enforcement organizations. Mechanism of guarantees of property rights work through administrative complaints in the Soviet property system, while they work via the statements of claim against violations of the contract obligations in private property system.

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<sup>27</sup> Nureev and Runov, *op cit.*, p. 14-5.

### 2.2.3.2.2 Property Relations in Practice

In the industrial sector, party leaders, ministry officials, managers of enterprises, local government officials, and workers in state enterprises were the main potential claimants of control over state property.<sup>28</sup>

The Party, particularly the Politburo was very influential in the administration and in the use of property in the means of production at all levels, and party officials were able to use their power to influence the distribution of the surplus and their own share of it.<sup>29</sup>

At the same time, in practice, the party officials could only be reached by close interconnection with several government officials specifically in the economic ministries. The control over state property by ministry officials tended to be more direct and concrete than that of party officials. In this regard, Whitefield argues that ministry officials were the most powerful actors in the economy by controlling the vast resources and directing enormous number of workers.<sup>30</sup>

The power of ministries in turn was also limited by the nature of the Soviet system, so there were sectional competition between different ministries and sectors. Besides, the power of government officials was limited due to their dependence on the Party.

At the regional and local levels, the power of the government officials to control state property was much more limited because they were dependent on central government for resources. They were also competing with each other for supplies from the center. They were under close control of the Party as local appointments were made according to the Party's *nomenklatura* system, and party officials were often strongly interventionist in local politics in order to guarantee local fulfillment of plan targets.<sup>31</sup> Nureev and Runov say

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<sup>28</sup> Cox, *op cit.*, p. 15.

<sup>29</sup> *Ibid.*

<sup>30</sup> *Ibid.* p. 16.

<sup>31</sup> *Ibid.*



that regional committees and municipal committees had an average level of control over state property.<sup>32</sup> At the same time, it should be mentioned that, both Party and government officials could improve regional loyalties where bureaucrats from different organizations in the same region could cooperate to provide their mutual interests against the interest of their superiors at the center.<sup>33</sup>

The control of the managers of enterprises over the state property was much more closer and immediate than any other group. That's why with the decrease of the central authority during the transition period they were in a powerful position to establish property rights over the ownership of the enterprises they managed. In spite of their strong position, they were under the supervision of Party secretaries in their enterprises and ministries, and also they were directly subordinate to officials at the central government level in different economic ministries and other agencies.<sup>34</sup> Nureev and Runov also say that directors of factories or managers were at the lowest level in the bureaucratic hierarchy.<sup>35</sup>

The weakest potential property holders were the workers of enterprises at the bottom of the chain of command. According to the Soviet ideology, the Party and state operated in the interests of the working class potentially fostered the foundation for a claim that state property was really workers' property. However, for most of the era of Soviet history industrial workers lacked any institutional basis from which to constitute and represent their interests. Enterprise councils or labor collective councils were cancelled in the 1920s until they were reinstated in 1993.<sup>36</sup> That's why Nureev and Runov do not contain workers in the framework of the bureaucratic structure.

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<sup>32</sup> Nureev and Runov, *op cit.* p. 14.

<sup>33</sup> Cox, *op cit.*, p. 16.

<sup>34</sup> *Ibid.*

<sup>35</sup> Nureev and Runov, *op cit.* p. 14.

<sup>36</sup> Cox, *op cit.*, p. 17.

The bureaucratic hierarchy discussed above was responsible from the preservation as well as the reformation of the Soviet system as a whole in the name of people. Bedirhanoğlu explains the strong power of the Soviet bureaucracy and Soviet *nomenklatura* with the following sentences:

The rapid development of an administrative-bureaucratic stratum during the Stalin years to manage not only the centralized economic system but also the ongoing revolutionary process had constituted a decisive step towards the formation of the self glorifying state class in the USSR, which had identified its own interests with the survival needs of the regime. This state class, or the *nomenklatura*, which was composed of not only the leading members of the all-powerful Communist Party and mass bureaucracy, but also the larger group of enterprise managers and the educated technical experts, was to be the main beneficiary of the Soviet system thereafter.<sup>37</sup>

## **2.3 Reform Attempts**

### **2.3.1 Systemic Problems of the Soviet Economy**

Mau says that the debate about ways of improving the efficiency of the Soviet economy began before the Second World War and there was a growing literature on the problems of the financial system, economic accountability, and commodity-money relations under socialism from the end of the 1940s.<sup>38</sup>

After the rapid growth rates of the early years, Soviet economic performance experienced a dramatic decline in the post Stalinist era. Soviet leaders had never been satisfied with the performance of the economic system. There was almost no year in which some change in the Soviet system was not introduced and some new experiment was not launched that anticipated possible future changes.<sup>39</sup>

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<sup>37</sup> Pinar Bedirhanoğlu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenklatura in the Neoliberal Era*, Unpublished Ph.D. Thesis Submitted to the University of Sussex, Sussex European Institute, The University of Sussex, 2002, p. 107-8.

<sup>38</sup> Vladimir Mau, *The Political History of Economic Reform in Russia, 1985-1994*, The Centre for Research into Communist Economies, 1996, p. 3.

<sup>39</sup> Edward A. Hewett, *Reforming the Soviet Economy*, Washington D.C., Brookings Institution, 1988, p. 221.

Soviet people were prepared to bear the poverty of Stalinist industrialization because of the threat from foreign enemies. But, after the 1950s, this perception changed as the USSR became the second big industry in the world and a superpower against the USA. The imperialist threat had been overcome and scientific technological success was achieved. Under these conditions, the ruling stratum should have given some concessions to the governed mass. Soviet leaders became aware of the public's troubles. Namely, the economic indicators of the Soviet Union and social and political tensions in the society due to the adaptation problem of the Soviet people to the system were confirming the need for reforms.<sup>40</sup>

There were many reasons of the reform attempts. One of them was related to the shortage of consumer goods. It is known that, Soviet industry was concentrated after 1928 on the production of capital goods through metallurgy, machine manufacture, and chemical industry as a strategic preference, so there was always a shortage of consumer goods. After the Stalinist period, Soviet people increasingly began demanding greater quantities of consumer goods.

Another one was related to the huge bureaucracy of the Soviet state structure. After the civil war, a fast bureaucratization emerged in the USSR. Expanded bureaucracy in the Soviet Union however became both the cause and the result of reforms.<sup>41</sup> Bureaucracy produced reforms, and reforms produced bureaucrats. Generally, until Gorbachev's *perestroika*, the reform attempts in the USSR had taken the form of decentralization or recentralization. The mean of decentralization was enforcement of central state organs, especially ministries, while the mean of recentralization was enforcement of enterprise managers. This huge and clumsy bureaucracy also caused difficulties in the practices of reforms.

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<sup>40</sup> Vladimir Mau, "Perestroika: Theoretical and Political Problems Of Economic Reforms In The USSR," *Europe-Asia Studies*, May 95, Vol. 47, Issue 3, pp. 1-24, p. 2.

<sup>41</sup> Antonio Carlo, *Sovyetler Birliğinin Sosyo Ekonomik Karakteri*, Çev. Emre Adıgüzel, Ankara, Kaynak Yayınları, 1985, p. 115.

Other reasons of the reform attempts were related in general to the deficiency of the planning process. Soviet industry could not provide incentives at all levels to improve growth, productivity and efficiency. Firstly, managers of enterprise were often more preoccupied with institutional careerism than with improving productivity.<sup>42</sup> They received fixed wages and only received incentives for plan fulfillment on the basis of job security, bonuses, and some benefits. Manager of enterprises received some benefits when targets were over-fulfilled, but when they were greatly over-fulfilled, they only saw their control figures increased.<sup>43</sup> Hence, there was an incentive to exceed targets, but not too much. Enterprises often understated capacity in order to bargain with the ministries for more advantageous plan targets or control figures.

Secondly, production quotas usually stipulated the quantity but not the quality of goods to be produced by a given factory. Therefore managers of enterprises were often tempted to meet their production quotas by sacrificing the quality of the goods they produced. Thus, much of the output of the Soviet economy was of very low quality by international standards. This led to the common problems of badly made machinery break down, and disrupted the rest of the economy.<sup>44</sup>

Lastly, enterprise managers were not able to deviate from the plan and were allocated certain funds for certain capital and labor inputs. As a result, managers could not improve productivity by dismissing unnecessary workers due to such labor controls. There was considerable underemployment due to controls in plans drafted during the collective bargaining between enterprises and ministries.<sup>45</sup>

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<sup>42</sup> Paul Hofheinz, "Gorbachev's Double Burden: Economic Reform and Growth Acceleration," *Millennium: Journal of International Studies*, Vol. 16, No. 1, pp. 21-53, p. 22.

<sup>43</sup> "Economy of the Soviet Union," Wikipedia, 2005, April 5, 2005.  
<http://www.answers.com/topic/economy-of-the-soviet-union>

<sup>44</sup> *Ibid.*

<sup>45</sup> *Ibid.*

Nove considers the growing complexity of the economy and the impossibility of adequate information to plan and administer the system centrally as the basic problem.<sup>46</sup> Kornai, meanwhile, focuses on the inability of the system to encourage enterprises to maximize productivity and profitability. The system was based on vertical bargaining between different levels of political hierarchy, and directives were formulated politically, so if plan targets were not met and an enterprise failed to operate profitably, constraints could be relaxed by a subsequent political decision.<sup>47</sup> Both of these arguments were implying that solutions might be found in the decentralization of some decision making in the management of the Soviet economy. On the other hand, Ellman sees the causes of the economic decline as the relaxation of the discipline in Soviet society since Stalin's time, and the growing loss of central control over the economy as it grew in complexity.<sup>48</sup>

Until the Gorbachev's reforms, there had been four identifiable reformist peaks: Khrushchev's reforms in 1957, the Brezhnev-Kosygin reforms in 1965, the 1973 industrial reorganization, and the 1979 reforms. All of these reforms aimed at balance, efficiency, innovation in the system, and responsiveness to customers, and all of them inspired from the previous reformist attempts.<sup>49</sup>

### **2.3.2 The New Economic Policy**

The "New Economic Policy" (NEP) was declared by Lenin at the 10th Congress of the Russian Communist Party in March of 1921. The NEP

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<sup>46</sup> Alec Nove, *The Soviet Economic System*, Allen and Unwin, London, 1980, p.89 quoted in Cox, *op cit.* p. 11.

<sup>47</sup> Janos Kornai, *The Socialist System: The Political Economy of Communism*, Clarendon, Oxford, 1992, p. 140-3 quoted in Cox, *op cit.* p. 11.

<sup>48</sup> M. Ellman and V. Kontorovich, *The Disintegration of the Soviet Economic System*, Routledge, London, 1992, p.13-4 quoted in Cox, *op cit.* p. 11.

<sup>49</sup> Hewett, *op cit.* p. 222.

replaced the emergency policy of War Communism<sup>50</sup>. In those years, Russia was primarily an agrarian nation, with a very small urban population and a weak industrial base. The Soviet industry was suffering from the problem of low productivity. Industrial output was at less than one-seventh of its pre-revolutionary level. Russia did not meet the economic criteria necessary for a full socialism.

The NEP was officially treated as a temporary withdrawal from the orthodox methods designed to facilitate the advance towards communism.<sup>51</sup> In this context, Lenin admitted that the NEP was a “retreat” and a “turning back toward capitalism”; however, he considered “special transitional measures” as necessary to form socialism in a peasant populated country.<sup>52</sup>

The NEP was proclaimed by a decree on March 21, 1921, titled "On the Replacement of Foodstuff and Natural Resource Assessment by a Natural Tax." It was introduced in order to revitalize the economy, increase food production, and promote business growth.<sup>53</sup>

Lenin also saw the NEP as a technological solution to the problem of low productivity in the Soviet industry. The non-Bolshevik engineers and economists (so called “bourgeois specialists”) were appointed to high positions in *Gosplan*. Additional technical assistance was obtained through the granting of foreign concessions.<sup>54</sup>

Under the NEP, the agricultural sector was increasingly privatized. Smaller businesses were permitted to operate as private enterprises. The NEP also allowed farmers to sell their crops on the open market after paying a tax proportional to their net yield. Government gave up taking all agricultural

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<sup>50</sup> An emergency economic policy, instituted during the Russian Civil War (1918-1921) that replaced market mechanisms with a quasi-military economic structure.

<sup>51</sup> Mau, “The Political History of Economic Reforms in Russia, 1985-1994,” p. 13.

<sup>52</sup> Been, *op cit.*, p. 80.

<sup>53</sup> "New Economic Policy," The Columbia Electronic Encyclopedia, Sixth Edition, Columbia University Press, 2003, June 18, 2005.  
<http://www.answers.com/topic/new-economic-policy>

<sup>54</sup> Bean, *op cit.*, p. 80.

surpluses from the peasantry. Peasants were also permitted to lease land and hire laborers. Thus, the peasantry won the right to organize its own independent family production for commodity exchange.<sup>55</sup>

On the other hand, the government maintained the control of “commanding heights” of the economy such as, the heavy industries, banks and financial institutions. Nevertheless, a private sector was formed by denationalizing small industry and leasing factories to cooperatives and capitalist entrepreneurs. State factories were authorized to buy and sell goods on the open market and to do business with “Nepmen”, the private merchant who were buying and selling items according to supply and demand.<sup>56</sup>

The NEP brought economic recovery. Prosperity increased the tax revenue. The private sector handled 75 percent of the retail trade and produced 90 percent of the agricultural output. Nepmen industrialists produced one-third of all consumer goods. The NEP succeeded in creating an economic recuperation after the devastating effects of the First World War, the Russian revolution and the Russian Civil War.<sup>57</sup>

Despite the return of prosperity, the Party was critical toward the NEP, as it favored industry and defense at the expense of consumer goods production. The farmers had little incentive to produce more. Workers welcomed the end of rations and the reintroduction of money wages, but they resisted other aspects of the policy. Under the NEP, industrial workers were supervised by three layers of management: union representatives, factory managers, and Party secretaries. Managers of factories hired workers on a temporary basis, enabling them to fire at will, and turnover and absenteeism were high. Thus, workers labeled the NEP the “New Exploitation of the Proletariat”.<sup>58</sup>

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<sup>55</sup> Cox, *op cit.*, p. 8.

<sup>56</sup> Bean, *op cit.*, p. 83.

<sup>57</sup> *Ibid.* p. 81.

<sup>58</sup> *Ibid.*

During the implementation of the NEP, state procurement policy was founded on buying grain from the peasants at the market price. After 1927, the state faced increasing problems in obtaining sufficient grain to meet its targets at prices it was willing to pay. Lenin's successor, Stalin in order to secure its political control over surplus appropriation, carried out the policy of forced collectivization to bring the peasants under direct state control and eliminated the private ownership of farmland.<sup>59</sup>

Stalin replaced the NEP with his own economic programs known as the Five-Year Plans. In the first Five-Year Plan (1928-1932), central planning replaced market mechanisms, and a strict state-controlled regime dominated the Soviet economy.

In this context, Mau argues that the sequence of events during the NEP was the first appearance of a feature of the conduct of reforms that was the characteristic of the entire Soviet history: cautious liberalization of economic life under pressure of crisis, soon replaced by a new conservative wave tightening the economic regime.<sup>60</sup>

The NEP influenced economic reformers in the Soviet Union. In the mid-1960s, Soviet economists revived the NEP model. In 1965, reformers were allowed to experiment with some NEP-like policies. Above all, Gorbachev expressed his economic reforms in socialist terminology and described his *perestroika* as a return to NEP-like policies. This will be argued in the following chapters.

### **2.3.3 Khrushchev Reforms**

Following Stalin's death, the ministries were seen as the primary reason of the economic decrease in view of substantial inefficiencies in the operation of enterprises. Khrushchev's opponents tried to weaken Khrushchev's power by reinforcing the control of the ministries and other central organs and by

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<sup>59</sup> Cox, op cit., p. 8.

<sup>60</sup> Mau, *The Political History of Economic Reforms in Russia, 1985-1994*, p. 13.



weakening control of the regional Party and government organizations, where Khrushchev's power base laid.<sup>61</sup>

Early in 1957 Khrushchev suggested the devolution of power to control the economy to regional councils (*sovnarkhozy*). The changes resulted in a transfer of power from the central apparatus to approximately 100 economic councils, which, under the supervision of the republican-level branches of *Gosplan*, directly controlled major enterprises in their territory. The ministries' supervising productive activities were virtually all banned, their powers were spread among the *sovnarkhozy*. The remaining central bodies (the Ministries of Trade and Finance, and even *Gosplan*) had seen their power reduced. *Gosplan* continued to control only the most critical national commodities.<sup>62</sup>

The aim of the reform was the elimination of departmentalism of the ministerial system, and replacing it with a rational division of labor within and between regions. At the same time the bonus system was given a major haul in 1959 to increase efficiency. Gross output was determining the enterprise bonuses. If the target for the growth of gross output was not fulfilled, no bonuses could be paid. However, the major bonus determining indicator became the target for cost reductions, usually measured per ruble of commodity production.<sup>63</sup>

In this reform period, contrary to the expectations, growth rates for national income and labor productivity fell dramatically, implying significant reductions in the efficiency with which productive factors were used. Real per capita consumption growth rates fluctuated in the late 1950s and early 1960s, but around a lower average than in the period immediately preceding *sovnorkhoz* reforms.<sup>64</sup> Hawett argues that it was difficult to identify variables that directly measure the impact of the reforms on economic performance since

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<sup>61</sup> Hewett, *op cit.*, p. 224.

<sup>62</sup> *Ibid.*

<sup>63</sup> *Ibid.* p. 225.

<sup>64</sup> *Ibid.* p. 226.

much of the reform was concerned with rationalization in intra-territorial specialization and production. At the same time, the declining growth rate at the beginning of the 1960s was probably the reflection of many influences, of which the *sovnarkhozy* reforms was only one.<sup>65</sup>

By the early 1960s there was a retreat from the *sovnarkhozy* reforms. As the most important part of them the number of *sovnarkhozy* dropped more than half to forty-seven and as an old economic body the VSNKh was resurrected to coordinate planning for economic activity at the union level. In appearance, one of the reasons of this outcome was Khrushchev's struggle to retain his position as party leader; the other was the low economic indicators. In fact, it is not difficult to claim that, the ministries were not ready to leave their autarky on locals. At the same time, it was being seen that local authorities were enforced to struggle with ministers in Moscow. This event was a clear example of this struggle of power.

Namely, these reforms had failed. The reasons of this outcome, according to an interpretation, were the enforcement of central authority through *sovnarkhozy* and the maintenance of strict practices of plan. According to another interpretation, it can be thought that, the empowered local authorities caused the growing second hand economy, a more corrupt relation between technocrats and workers.

**Table.2.1 Selected Macroeconomic Growth Rates (percent), 1955-62**

Year	National income produced	Labor production in industry	Real income per capita
1955	11.9	9.5	0.9
1956	11.3	7.0	5.9
1957	7.0	6.6	8.7
1958	12.4	6.2	5.9
1959	7.5	7.4	1.8
1960	7.7	5.4	6.4

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<sup>65</sup> *Ibid.* p. 227.

**Table.2.1 (continued)**

<b>Year</b>	<b>National income produced</b>	<b>Labor production in industry</b>	<b>Real income per capita</b>
1961	6.8	4.4	1.6
1962	5.7	5.5	3.2

Source: Edward A. Hewett, *Reforming the Soviet Economy*, Washington D.C., Brookings Institution, 1988, p. 227.

### **2.3.4 Kosygin Reforms in the 1960s**

The first important sign of the Kosygin reforms was Evsei Liberman's article 'Plan, Profit, Bonus' published in September 9, 1962 edition of *Pravda*. This article launched one of the extensive debates in the whole history of Soviet economics.<sup>66</sup> Liberman, as quoted in Hewett, stressed that enterprises should be encouraged to seek out and use their full productive capacities, make better the quality of goods produced and curb their strong appetite for new capital and additional workers. Furthermore, he also supported the elimination of unwarranted central interference in enterprise activities. Liberman suggested achieving these goals by significant reductions in the obligatory plan indicators related to product mix, deliveries, and profits.<sup>67</sup> Of course, the proposal advanced by the reformers under the leadership of Liberman in the first half of the 1960s resulted in sharp oppositions from economists of a conservative and moderate persuasion.

The economic discussions of the 1960s were not purely a phenomenon confined to academic life. They resulted in the 1965 economic reform, the most far reaching attempt at reform of the Soviet economic management until *perestroika*. In the literature it is frequently called the Kosygin reforms, referring to the Chairman of the USSR Council of Ministers, Kosygin, who was the man who prepared the reforms and secured the political decision to

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<sup>66</sup> Mau, *The Political History of Economic Reform in Russia, 1985-1994*, p. 19.

<sup>67</sup> An English translation of the Liberman piece is available in Morris Bornstein and Daniel Fusfeld, *The Soviet Economy: A Book of Readings*, Homewood Ill, Irwin, 1966, pp. 352-58 quoted in Hewett, *op cit.*, p. 228.

carry them out.<sup>68</sup> Aslund argues that as the Kosygin reforms lacked support at the highest political level, they could not be implemented in full.<sup>69</sup> Alexi Kosygin announced a set of measures at the September 1965 Plenum of the Central Committee. They consisted of three basic aims: an administrative reform reestablishing the ministerial system, a complete revision of the enterprise incentive system, and a price reform.<sup>70</sup>

Concerning the general characteristic of these reforms, it can be said that some parts of these reforms had a tendency for centralization, on the other hand it was true that these reforms brought new powers to enterprises especially about enhancing profitability and setting prices. In the Western economic literature, the aim of these reforms was defined as decentralization.

Starting with the administrative reform, the 1965 decree transferred the power of regional planning authorities to twenty-three newly constituted industrial ministries. Additionally, existing state committees –for instance *Gosplan*- assumed greater authority and responsibility as a result of the 1965 decree. At the same time other committees such as most notably *Goskomsent* (Prices), *Gossnab* (material and technical supply) and *GKNT* (Science and technology) were established in the fall of 1965. This reform enforced the hands of authorities in Moscow and had the most lasting impact among the reforms.<sup>71</sup>

It reintroduced a decision making hierarchy that Stalin had used to manage the economy, and expanded the number of ministries and state committees. After 1965, this ministerial hierarchy was steadily expanded in

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<sup>68</sup> *Ibid.*, p. 230.

<sup>69</sup> Aslund, *Gorbachev's Struggle for Economic Reform*, Ithaca, New York, Cornell University Press, 1989, p. 10.

<sup>70</sup> Hewett., *op cit.*, p. 230.

<sup>71</sup> *Ibid.*, p. 243.

scope in a constant effort by successive Soviet leaders to administer the increasingly complicated system.<sup>72</sup>

The second part of the Kosygin reforms was related to enterprise incentive system. The system of the obligatory plan targets was changed completely by a decree in September 1965. By this obligatory decree, targets to individual enterprises were reduced from forty to only eight. The gross output indicator was replaced by a target for sales volume, still though the targets for costs were not part of the obligatory targets.<sup>73</sup>

At the same time, this decree launched a new bonus system which depended on the achievements of the enterprises. From this point of view, these new regulations gave larger capability to enterprise managers to maximize their profits, and enterprises started enjoying the benefits and losses of their own. Thus, the new system made it difficult for ministries to intervene in enterprise operations.

However, a few indicators that ministries were authorized to pass on to enterprises left each ministry, and therefore central planners, with considerable influence over the details of enterprise activities. Namely, the planners and ministries continued to determine the production function for the enterprises centrally.

The third component of the Kosygin reforms was related to the revision of price setting mechanism. The prices were freed from the interference of the central plan directives via this revision. At the end of this process, virtually all industries and enterprises were able to operate profitably in the new price environment. On the other hand, because of this new price system a significant number of factories were closed.

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<sup>72</sup> *Ibid.*

<sup>73</sup> Antonio Carlo, *op. cit.*, p. 159.

#### 2.3.4.1 Implementation of the Kosygin Reforms

The administrative reform was the most rapidly implemented one among the reforms. Price system and enterprise incentive system could not be implemented until 1967. Price reform began in October 1966 with changes in retail prices for light and food products, and the new wholesale prices for heavy industrial products started on July 1, 1967.<sup>74</sup>

Enterprises incentive reform was implemented very slowly. By the end of 1966, only 1.5 percent of industrial enterprises were operating under the new regulations. In 1967, the first serious effort at implementation began and by the end of the year, 15 percent of industrial enterprises were operating under this new system. The aim of this reform was first to add the most profitable enterprises in the system and leave to last those that would have the most difficulty in financing bonus payments under the new rules. That criterion was most likely responsible for the slowing down of the implementation of the reforms in the late 1960s.<sup>75</sup>

At the same time, with other measures, implementation went even more slowly. For instance expansion of wholesale trade was not operated. *Gossnab* delayed introducing this system of direct ties between enterprises and buyers.

Implementation process was slow since there were delays resulting from the system. The ministries and the *glavki* (sub-divisions of ministries) tried to delay the reforms by using such ways as assimilation, complication, regulation. Firstly, they tried to assimilate new procedures into old bureaucratic procedures. Second tactic of delay was complexity. Ministries used the multiplicity to further complicate the regulations and instructions. Finally, the third tactic was the violation of the statutes and persistence in formal or informal continuation of more than the allowed number of obligatory indicators.<sup>76</sup> Bedirhanoglu interprets the resistance of the ministries concerning

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<sup>74</sup> Hewett., *op cit.*, p. 236.

<sup>75</sup> *Ibid.*

<sup>76</sup> *Ibid.*, p. 237.

the implementation of the reforms as a way for the maintenance of the Soviet *nomenklatura* rule:

Particular political function ensured by the centralized economic organization was crucial for the maintenance of the *nomenklatura* rule, and this was exactly why most of the sound reform proposals, which tended to decentralize the decision making process in production and distribution, were either not implemented or crippled in practice until the mid-1980s.<sup>77</sup>

The administrative recentralization had the most lasting impact among the reforms. As mentioned before, it reintroduced a decision making hierarchy that Stalin had used to manage the economy and expanded the number of ministries and state committees. While many of the Kosygin reforms were eliminated later, this administrative hierarchy was preserved and made even more complicated by the successive Soviet leaders after 1965.<sup>78</sup>

The price reform could not be implemented fully. After the reform there was still a fixed-price, supply-oriented price system unresponsive to changes in demand, or even to changes in domestic cost.<sup>79</sup>

The enterprises incentive system was never fully implemented. The new regulations affected the system only formally. The *de facto* system remained one in which outputs were the key determinant of bonuses, and other indicators such as sales ability were given a secondary importance.

#### **2.3.4.2 The Impact of the Kosygin Reforms on Economic Performance**

Although the reforms in the 1960s were not implemented entirely, the economic performance somehow improved after the Kosygin reforms.

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<sup>77</sup> Bedirhanoğlu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenklatura in the Neoliberal Era*, p. 111.

<sup>78</sup> Hewett., *op cit.*, p. 244.

<sup>79</sup> *Ibid.*, p. 236.

**Table 2.2 Selected Macroeconomic Growth Rates (percent), 1961-72**

<b>Variables</b>	<b>1961-65</b>	<b>1966-72</b>
National income produced	6.5	6.9
Industrial output	8.6	8.1
Labor productivity in industry	4.6.	5.8
Real per capita income	3.5	5.5

*Source:* Edward A. Hewett, *Reforming the Soviet Economy*, Washington D.C., Brookings Institution, 1988, p. 239.

This table shows the success in three variables: national income produced, labor productivity in industry, and real per capita income. These results exhibit that, in the period during and immediately following the implementation of the 1965 reforms economic performance improved in compared to the past five years. National income growth rates were slightly higher, even though industrial output had fallen somewhat. Most importantly, the national income growth rates did not fall, and a marked improvement in labor productivity growth rates in industry and a dramatic improvement in the growth rate of real per capita incomes were realized.

In conclusion, as a result of the Kosygin reforms, new branch ministries were established and the power of Moscow increased. Furthermore, while the dominant role of plan indicators was reduced, the role of value instruments was enhanced by new enterprise incentive system. The main reason of this contradictory situation was that although the fundamental ideas of reform were put forward by some economists like Liberman, the normative documents were prepared by others known as more moderates, and the practical implementation was directed by those who were even objectors of the basic ideas of reform.<sup>80</sup>

The failure of the 1965 reforms served as the background for two further efforts to improve the Soviet system in the 1970s.

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<sup>80</sup> *Ibid.*, p. 244.



### 2.3.5 The Reform Attempts in the 1970s

Two main reform attempts were put into practice in the 1970s. Brezhnev's two decrees in March 1973 aimed to change the decision-making hierarchy by simplifying the administrative apparatus of ministries and merging enterprises with production associations. These regulations were made by the spirit of centralization.

#### 2.3.5.1 The 1973 Reforms

The basic aim of the 1973 reforms was to reduce the size of the administrative hierarchy in industry and increase the efficiency with which industrial enterprises were managed by the center. The basic tools of these reforms were associations, which were conceived and supervised by the ministries.<sup>81</sup>

“All Union Industrial Associations” (*Vsesoiuznie Promyshelnnie Ob"edinenie*, *VPOs*) whose authority would in general cover similar enterprises throughout the USSR were established. Brezhnev intended to redirect each ministry's efforts toward long-range planning and technical progress in the sector as a whole rather than daily management of enterprises.

The *VPOs* were to be much more independent from the Ministry than the *glavki*. Their job was to actually supervise the operation of the production associations and enterprises, research and design organizations and technical institutes.<sup>82</sup>

At the same time due to this reform, another establishment was formed: the Scientific Production Associations, (*Nauchno-Proisvodstvennie Ob"edinenie*, *NPOs*). Soviet officials combined all the necessary components to conceive, design, and produce new technologies under this one organizational structure. *NPOs* were to contain their own research and design institutes with accompanying factories capable of producing and testing prototypes, all

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<sup>81</sup> *Ibid.*, p. 245.

<sup>82</sup> *Ibid.*, p. 246.

attached to one or more major entities engaged in serial production of related products.<sup>83</sup>

During the implementation of the reform, the ministries pursued their conservative attitude and many of the preliminary plans submitted by ministries were rejected for they were reluctant to mergers or to give up direct control over enterprise activities.

Continuing pressure from the government finally bore its fruit in a massive merger movement in industry. By 1975, the number of NPOs reached up to 2314, which accounted for 24.4 percent of industrial output. This figure increased and in the early 1980s there were nearly 4200 production and scientific production associations, which accounted for one-half of industrial output. But, it was a fact that, many of the mergers had little or no effect on the actual decision making of the member enterprises. Since all of the production associations were formed within the ministries, ministerial autarky was preserved, a totally predictable outcome of the decision to put the ministries in charge of the planning and the execution of mergers.<sup>84</sup>

Like the 1965 reforms, the 1973 mergers were not accompanied by any change whatsoever in the central planners' anticipation that ministries would be held responsible for providing the economy with reliable supplies of 'their' products produced by 'their' enterprises and associations. There was no incentive for the ministries to empower the VPOs with new authority. VPOs, together with the ministries, continued to control enterprise behavior as they did in the past.<sup>85</sup>

Ultimately, the 1973 merger movement had almost produced none of the consequences the leadership had hoped for. Ministries managed to protect their authority over production units by assimilating the new measures into the existing system.

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<sup>83</sup> *Ibid.*, p. 247.

<sup>84</sup> *Ibid.*

<sup>85</sup> *Ibid.*

This movement indicated some lessons about the reform efforts in the USSR. Firstly, it was naive to give to ministries the task of designing and implementing a reform that would reduce their powers. Second, the efficiency problems in the Soviet system could not be overcome with only supply-side solutions; demand-side solutions should be also considered.<sup>86</sup>

Eventually, the Soviet approach of ordering mergers from the center was another example of the central planners' conviction that they knew the best for all economic units in the system. Thus, the Soviet leaders erected, not for the first time, a *facade* suggesting change. Behind it, the system continued to function as it used to be in the past.<sup>87</sup>

### **2.3.5.2 The July 1979 Decree**

The July 1979 decree "On the Improvement of Planning and Strengthening of the Action of the Economic Mechanism" proposed substantial changes, most of which were somehow related to the incentive system.<sup>88</sup> This decree in many ways represented an extraordinarily complex completion of measures announced but not implemented since 1965. However, it also sought to introduce some new ideas, most notably a reliance on calculated value-added index as primary bonus-forming indicator for enterprises.<sup>89</sup>

The aim of this decree was to encourage enterprises to operate as closely as possible to their full productive capacities by increasing the efficiency of their use of human and physical inputs. Another aim was the timely delivery to customers of products actually in demand in the system.

The measures introduced fall broadly into two categories: planning and supply, and performance indicators. Concerning planning and supply, one of the important goals of the Decree was to enhance the role of five-year plans by

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<sup>86</sup> *Ibid.*, p. 249.

<sup>87</sup> *Ibid.*, p. 250.

<sup>88</sup> Hofheinz, *op cit.*, p. 23.

<sup>89</sup> Hewett, *op cit.*, p. 251.

relegating annual plans to their originally intended role for elaboration, but it was not a typical major revision of five-year plans. The other category was related to performance indicators. Possibly the most innovative step taken was to make 'normative net output' (NNO) the main indicator for enterprise activities. NNO measures were outputs, which were value-added by the enterprises by using actual quantities. These outputs were multiplied by a branch wide range of the value-added products in each production. Thus an enterprise that used more labor than the branch average would not be rewarded for doing that and would have to accept the normative rather than its actual value-add; an enterprise using less than branch average labor inputs would be rewarded. The value-added weights that go into the calculation were set by *Goskomsent* and issued in 1981, along with new price list to take effect in 1982. NNO was to be used in the calculation of the two primary bonus-forming indicators for enterprises: labor productivity and the proportion of highest-quality goods in total output.<sup>90</sup>

Although two prime determinants of bonus payments were specified in the 1979 decree, ministries were also allowed to include in enterprises' plans eighteen other indicators, the most important ones being the production of principal products in physical units, norm wages per ruble of output, the number of employees, the commissioning of new capacities, and goals for production costs. Some of these had to be fulfilled before the enterprises paid out bonuses; and others had relatively small bonuses attached to them.

The 1979 decree was an attempt to improve the central control over microeconomic decisions, but in no fundamental way did it seek to change that control. In particular all signs indicated that the center had continued to enforce its wishes with regard not only to the final results of enterprise activity, but also to the methods used to obtain these results.

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<sup>90</sup> *Ibid*, p. 250.

## 2.4 Conclusion

In this chapter, the general features of the Soviet economic and political system and reform attempts from 1917 to 1985 were overviewed. As seen, in this period, there were many reform attempts to revise the production relations. Almost all reforms aimed at reducing bureaucratic mechanism, deficiencies of the planning process, and enhancing employees' incentives. Many of these reform attempts generally started with some legislation, but later implementation could not be practiced entirely. The main reason of this outcome was the fact that *nomenklatura* or state class was happy with the existing power mechanism, thus, they opposed any reform attempts which would diminish their control over the state property.

The implementation was the hardest stage of the reform attempts due to the resistance of lower levels of the *nomenklatura* against centralization, and upper levels against decentralization. The Soviet *nomenklatura* used the reforms as a way to maintain its authority over the centralized economic system and production relations.

As again discussed in the chapter, reform attempts until the Gorbachev period were related to some moderate changes in production relations and did not aim at privatization in any way.

Despite these reform attempts, Soviet production relations did not change considerably. The economic indicators of the USSR continued to deteriorate substantially until the 1980s. Many writes assess the period from the beginning of the 1980s until the Gorbachev era as a 'stagnation period.' Thus, the reform needs of Soviet system continued increasingly. Due to this and other reasons discussed in the next chapter, Gorbachev initiated a radical reform process in the middle of 1980s, which had both similarities with and differences from the previous reform attempts.

## CHAPTER 3

### GORBACHEV REFORMS

#### 3.1 Introduction

In this chapter, the Gorbachev period will be examined in terms of the changes related to the property relations in the USSR. Initially Gorbachev's traditional reform attempts will be explained. Gorbachev in his early years tried to change the system partly as did his predecessors. While the system preserved its basic socialist principles such as central planning and public property, Gorbachev adopted some different reforms in his first two years of administration such as anti-alcohol campaign and better quality standards.

After 1987, Gorbachev's reforms entered a new stage, which will be defined in this thesis as moderate reforms. In this period, *perestroika* anticipated a shift in the balance of power within the public sector from ministries and party officials to enterprise managers and workers. By diminishing the amount of ministries' direct intervention, enterprise managers and workers were permitted to exercise their own initiatives and improve economic performance under the stimulus of the market.

In 1989, with the adoption of the Law on Cooperatives, Gorbachev's reforms started to become more radical. This law initiated the first example of private enterprise which was much extensive than previous implementations like individual self employment or family business.

Gorbachev's reforms became increasingly more radical in time. Therefore, his reforms will be explained in three categories such as traditional, moderate and radical ones. In order to provide a better understanding of the political context of these reforms, important political developments will be examined until the formal collapse of the Soviet Union.

### 3.2 Gorbachev's Reformist Posture

When Mikhail Gorbachev became the General Secretary of the CPSU Central Committee on March 11, 1985, there were many expectations that the new General Secretary would introduce economic reforms to improve the Soviet economy because of his reputation as a reformist.<sup>91</sup>

Gorbachev's reformist character was clear in the periods that he occupied second or third place in the Soviet hierarchy. He had read the Novosibirsk report of April 1983 which included one of the most vigorous critiques of the Stalinist command economy.<sup>92</sup> Gorbachev's speeches preceding his election for the post of the General Secretary showed that throughout 1984 he was thinking intensely about the problems and difficulties of the Soviet economic system.<sup>93</sup>

Until Gorbachev's coming to power in 1985, urgent problems of the Soviet economy could not be addressed comprehensively partly due to the reasons discussed in the previous chapter. There were clear indications that something was going wrong. Especially, there was a long term decline in the growth rates. According to the Eleventh Five Year Plan for the 1981-85 periods, the growth rate could reach only to 2.5 percent.<sup>94</sup>

Moreover, the depressed state of the Soviet economy threatened the status of the USSR as a superpower. By 1980, the Soviet Union had lost its claim to be the world's second largest economy.<sup>95</sup> At the same time, after 1978 the Soviet Union began to run a budget deficit which by 1985 reached to 37 billion rubles.<sup>96</sup> Also production costs were steadily rising, while prices were

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<sup>91</sup> Hofheinz, *op cit.* p. 21.

<sup>92</sup> Sakwa, *Gorbachev and His Reforms, 1985-1990*, New York, Prentice Hall, 1990, p. 269.

<sup>93</sup> Mau, "Perestroika: Theoretical And Political Problems Of Economic Reforms in The USSR," p. 2.

<sup>94</sup> Hofheinz, *op cit.* p. 24.

<sup>95</sup> Peter Rutland, "Economic Crisis and Reform" in S. White, A. Pravda and Z. Gitelman (eds.), *Developments in Soviet and Post-Soviet Politics*, Macmillan, pp. 200-226, p. 204.

<sup>96</sup> Sakwa, *op cit.*, p. 272.

held constant. The gap was filled by government subsidies.<sup>97</sup> After 1985, besides these structural problems, there emerged a series of exogenous shocks such as falling of world oil prices, Chernobyl, and the Armenian earthquake.<sup>98</sup> All of these factors brought the economy to the point of collapse.

It can be argued that Gorbachev's initial aim was to bring about only a sufficient change to enable the system work efficiently. He did not believe at the outset that the system had to be reformed with its roots and branches, rather he believed that a series of smaller-scale changes would be sufficient to restore the system to health.<sup>99</sup> It seems also clear from Gorbachev's early speeches that he did not think a radical overhaul of the system of central planning was required.<sup>100</sup>

Gorbachev declared his intention clearly in a speech to the Party members on December 10, 1984, and used the key words of his reforms, *uskorenie* (acceleration), *glasnost* (openness), and *perestroika* (restructuring).<sup>101</sup> In the first two years of his administration, he primarily tried to carry out *uskorenie* through his traditional reform attempts followed by some *glasnost* policies. As he did not see any considerable results, he started to adopt *perestroika* in the late 1980s with the Law on Individual Labor Activity.

Gorbachev's reform attempts became increasingly more radical due to the resistance of *nomenklatura* against reforms. Thus, after 1988 Gorbachev initiated some reforms which include a revolutionary intervention into the Soviet production relations by trying to ensure the active participation of people in politics.

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<sup>97</sup> Rutland, *op cit.*, p. 204.

<sup>98</sup> Sakwa, *op cit.*, p. 272.

<sup>99</sup> Graeme Gill and Roger D. Marwick, *Russia's Stillborn Democracy? From Gorbachev to Yeltsin*, Oxford, Oxford University Press, 2000, p. 27.

<sup>100</sup> Rutland, *op cit.*, p. 208.

<sup>101</sup> Sakwa, *op cit.*, p. 6.



### 3.3 Traditional Reform Attempts

The Soviet economic reforms during Gorbachev's initial period (1985-86) were similar to the reforms of the previous leaders.<sup>102</sup> The period of *uskorenie* was mainly about modifying the administrative command system without making truly fundamental changes. He used some very traditional methods to try and improve the economic performance.<sup>103</sup>

- Disciplining individuals to work properly rather than changing institutions,<sup>104</sup>

- Organizing the economic system to make it work faster and more efficient,

- Achieving accelerated economic growth by imposing an ambitious five-year plan (the twelfth five-year plan).

Gorbachev argued that the Soviet economy's decline could be traced to the system's failure to increase people's interest in their work.<sup>105</sup> He felt that the only solution to this problem would be the radical decentralization of power and transfer of responsibility from the ministries to the enterprises. In this sense, a Politburo decree was issued in August 1985 'On the Board Dissemination of the New Methods of Economic Management and Technical Progress'. According to this decree, enterprises were allowed to set up material incentive funds and were granted more investment authority. Enterprises could invest any amount up to four million rubles without central authorities.<sup>106</sup>

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<sup>102</sup> Simon Clarke, "The Crisis of the Soviet System" in S. Clarke, P. Fairbrother, M. Burawoy, P. Krotov (eds.) *What about the Workers? Workers and the Transition to Capitalism in Russia*, London, New York, Verso, pp.30-55, p. 38.

<sup>103</sup> Walker, *op. cit.*, p. 77.

<sup>104</sup> In the first phase of the *perestroika*, 1986-87, Gorbachev and his team adopted a wage reform which determined worker's salary levels according to their quality and quantity of work, launched an anti-alcohol campaign in 1986 to improve labor discipline, and a 1987 campaign to improve product quality through a system of independent quality inspection.

<sup>105</sup> Hofheinz, *op. cit.*, p. 26.

<sup>106</sup> *Ibid.* p. 27.

Gorbachev announced his intention of transferring all of the ministries, enterprises and work brigades to ‘full *knozhraschet*’<sup>107</sup> at the 27<sup>th</sup> Party Congress in 1986. He had sharp words for the managers of factories that operated at a loss and called for steps to be taken to make people pay from their own pockets for inefficient or bad labor.<sup>108</sup> He also expressed that enterprises should be allowed to sell any products they made in excess of the Plan.

Gorbachev also saw the amalgamation of several ministries to create ‘super ministries’ as a way of cutting down the amount of bureaucracy and devolving operational decisions to associations of enterprises.<sup>109</sup>

Gorbachev’s traditional reform methods aimed to reallocate power within the *nomenklatura* in favor of its technocratic section. Enterprise managers saw also all these managerial reforms as a way to translate their economic power into a recognized political authority.<sup>110</sup>

At the same time, *glasnost* was another policy promoted by Gorbachev since the beginning of his reforms. Its central feature was to improve the production and circulation of accurate information in the system. Gorbachev also anticipated that it would make officials more accountable and help to create a more constructive atmosphere in the Soviet workplace. In practice, *glasnost* did not meet the expected results. Chernobyl catastrophe was an indication of how limited *glasnost* was. In this event, the Politburo and Gorbachev initially received inaccurate information as to what had happened there. The reports of the catastrophe were prepared to conceal the responsibility

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<sup>107</sup> This word was usually translated as ‘economic accounting’, ‘cost accounting’ or ‘profit and lost accounting’, but no English phrase can cover its various meanings, which includes an enterprise covering its expenses from sales and thus introducing some forms of profit motives. This term was one of the main slogans of the early NEP period and had hesitantly been re-introduced into the Soviet industry after the 1960s (Sakwa, op. cit., p. 278).

<sup>108</sup> Hofheinz, *op cit.*, p. 25.

<sup>109</sup> Cox, *op cit.*, p. 50.

<sup>110</sup> Bedirhanoglu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenklatura in the Neoliberal Era*, p. 27.

of the management of the Chernobyl power plant.<sup>111</sup> The full scale of the Chernobyl catastrophe was hidden for several years.<sup>112</sup>

At the end of this initial period, accelerated economic growth was not realized and economic decline continued. The budget deficit remained as a main economic problem. All these factors undermined Gorbachev's public credibility as a reformer.<sup>113</sup> Additionally, the decentralizing managerial reforms of Gorbachev had diminished the initial support of the military industrial complex, one of the most powerful socio-economic group in the USSR.

By the mid-1986, after the Chernobyl catastrophe, Gorbachev started to admit that some sort of radical restructuring of the economic mechanism was required.<sup>114</sup>

### **3.4 Moderate Property Reforms**

Gorbachev administration after 1986 entered a new reform process related to the managerial system of Soviet production relations in the context of *perestroika*. On this purpose, two important laws were introduced. These laws were the Law on Individual Labor Activity and the Law on State Enterprises. While the first law allowed the individuals to work privately in some areas, the second one approved the operation of state enterprises with greater autonomy based on a profit and loss calculation. According to this law, managers and workers of state enterprises would be responsible for their loss, and the state would no longer rescue the loss making enterprises.

At the same time, Gorbachev had provided some state enterprises with more autonomy by giving them the right to trade directly with foreign firms without formal authorization of the Ministry of Foreign Trade.<sup>115</sup>

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<sup>111</sup> Daniloff Nicholas, "Chernobyl and Its Political Fallout: A Reassessment," *Demokratizatsiya*, Volume 12, Number 1, Winter 2004, pp. 1-16, p. 11.

<sup>112</sup> Sakwa, *op cit.*, p. 78.

<sup>113</sup> Walker, *op cit.*, p. 78.

<sup>114</sup> Rutland, *op cit.*, p. 209.

<sup>115</sup> Hofheinz, *op cit.*, p. 28-9.

Clarke assessed this initiation as an attempt to break the monopoly of the Ministry of Foreign Trade and to make enterprises more responsive to world market pressures by providing them with the means and the incentives to enter export markets on their own account.<sup>116</sup> This initiative did not relieve the Soviet economy because of the falling energy and rising grain prices in world markets, and the indicators of the USSR foreign trade declined by 12 percent from 1986 to 1987, bringing about a further deterioration of the budget deficit.<sup>117</sup>

### **3.4.1 Law on Individual Labor Activity**

As a first sign of real innovation in the Soviet system, the Law on Individual Labor Activity was adopted by the Supreme Soviet on November 19, 1986 and scheduled for implementation on May 1, 1987.<sup>118</sup> On the other hand, a harsh law against ‘unearned income’ had already banned the unofficial private initiatives a short while ago (on May 28, 1986).<sup>119</sup>

This new law consolidated the general provisions stated in the 1977 Constitution by conforming, in general, the legality of private work for individuals. It specified more clearly what kinds of work activities were legal. Among the permitted activities were the manufacture and repair of clothing, furniture, pottery and toys, the construction and repair of houses and other domestic buildings, repair of cars, radios and other electrical and household appliances, hairdressing and cosmetic services, private transport services, private tutoring and some medical services.<sup>120</sup> It also established the

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<sup>116</sup> Clarke, “The Crisis of the Soviet System,” p. 39.

<sup>117</sup> Bedirhanoğlu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenklatura in the Neoliberal Era*, p. 128.

<sup>118</sup> Cox, *op cit.*, p. 70.

<sup>119</sup> Sakwa, *op cit.*, p. 280.

<sup>120</sup> Cox, *op cit.*, p. 71.

procedures for registration and regulation of individual work.<sup>121</sup> In practice, the return to private enterprises was strictly limited, permitting only groups of family members to work in one business. The work was to be carried out only in a person's spare time from a state job.<sup>122</sup> Some of the rules were later relaxed.

Thanks to this law, investment shifted to consumer sector, which was planned to grow 2.3 times faster than heavy industry in 1989. The 1989 draft plan approved by the Supreme Soviet on October 28, 1988 was for the first time oriented towards meeting consumer needs. Moreover, new laws on consumer protection were drafted.<sup>123</sup>

### **3.4.2 Law on State Enterprises**

Law on State Enterprises of 1987 was another reform initiative that aimed at decentralization in the industrial sector. This law targeted to make state enterprises self-accounting so that they were freed from many of the direct controls by their branch ministries and allowed to operate on a profit and loss basis.<sup>124</sup> It was intended that if the state was no longer to rescue loss making enterprises, managers and employees would have to deal with their jobs and incomes by becoming more profit oriented. Government would exercise only a general strategic control by 'state orders' specifying levels of production, and "normatives" indicating the extent to which factors of production and social cost would be covered by state budgets.<sup>125</sup> Within this framework, enterprises would be able to enter into contracts with suppliers and customers after fulfilling state orders for their ministries. This law increased the technocrat's hold over the productive resources.

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<sup>121</sup> *Ibid*, p. 70.

<sup>122</sup> Sakwa, *op cit.*, p. 280.

<sup>123</sup> *Ibid*.

<sup>124</sup> Cox, *op cit.*, p. 53.

<sup>125</sup> *Ibid*, p. 99.

This law gave the enterprises the rights of possession, use and administration of their assets. Moreover, it gave them the right to transfer their assets. Thus, enterprises could escape from central control by transferring productive activities to subsidiary enterprises, which were not subject to ministerial regulation or control.<sup>126</sup>

The Law on State Enterprises introduced a radical initiative to improve the quality of the “human factor” in production. The law, though increasing the managers’ freedom to determine the policy of their enterprises, gave the enterprise workforce increased influence by providing them with the right to elect their managers and the council of labor collective.<sup>127</sup>

In practice however, this law failed and was thought to be responsible for exacerbating the ongoing economic crisis. Clarke esteemed this law as a simple paper reform, allowing actually the center to take back what it had given. Whatever the juridical changes, the ministries continued to hold power.<sup>128</sup> Ministries maintained their right to impose state orders. At the same time, both investment and supply of materials were not decentralized and managers continued to rely on state orders for the provision of them.<sup>129</sup> Moreover, the elections of managers and enterprise councils usually did not happen; when some elections took place, they did not result in any important change either in the management personnel or in the policies.

The reformist group saw these two laws as ways to strengthen the popular and technocratic support base after having seen the impossibility of meeting the expectations of the *nomenklatura*. This situation brought about a conflict of interests within the *nomenklatura* as Gorbachev and his team were

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<sup>126</sup> *Ibid*, p. 207.

<sup>127</sup> Cox, *op cit.*, p. 53.

<sup>128</sup> Clarke, “Privatization and The Development of Capitalism in Russia,” in S. Clarke, P. Fairbrother, M. Burawoy, P. Krotov (eds.) *What About the Workers? Workers and The Transition to Capitalism in Russia*, London, New York, Verso, pp. 199-241, p. 206.

<sup>129</sup> Cox, *op. cit.*, p. 100.

supported by the technocrats or specialists and managers while conservatives such as upper Party cadres and branch ministries opposed them.

To sum up, the first wave of *perestroika* brought only juridical changes, and it was largely ineffective in achieving important improvements in either productivity, distribution of goods, or quality of production. Thus, it was seen that the failure in the implementation of these laws caused a new radical reformist debate on production relations and ownership issue in the Soviet Union.

### **3.5 Radical Property Reforms**

#### **3.5.1 Law on Cooperatives**

Law on Cooperatives was passed on May 26, 1988 to be implemented on July 1, 1988 as another law of Gorbachev's reform attempts. The new law on cooperatives began by clearly establishing the socialist respectability of cooperatives. Cooperatives were no longer to be considered as a secondary or transitional form of property which would finally be replaced by more fully socialized forms of enterprise. Rather they were to be regarded together with state enterprises as the main components in the unified national economic system.<sup>130</sup> Work in cooperatives was honorable and prestigious and was encouraged in every possible way.<sup>131</sup>

The main articles of the law were as follows:<sup>132</sup>

- State and public organizations were going to be banned from interfering in the management of cooperatives. Nevertheless, juridical authorities could interfere with cooperatives in cases of lawbreaking, and financial authorities could interfere with cooperatives in cases of the collection of taxes.

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<sup>130</sup> Sakwa, *op cit.*, p. 292.

<sup>131</sup> Cox, *op cit.*, p. 83.

<sup>132</sup> All of these provisions were taken from Cox, *op cit.*, p. 83.

- Cooperative ownership was admitted as one of the forms of socialist ownership. Cooperatives completely owned their property and they could sell, lease, transfer or merge their property as they want.

- The role of the state was limited in the regard of the setting up of a cooperative. After cooperatives were registered by the state, they were to be responsible for drawing up their own business plans independently. Nevertheless, the business planning process should be coordinated with the state plan. At the same time, cooperatives had the authority to decide their own prices except in cases where the cooperative accepted a state order. In such cases the price would be agreed with the state partner organization in advance.

- Cooperatives should be able to use in any form of production or provision of service except where the activity concerned was explicitly banned to cooperatives by the law. The concerning authorities, both at the central and republican levels, would issue lists of such banned activities.

- Any adult Soviet citizen could take part in cooperatives as a member. All cooperative members should work for their cooperative, at least on a part time basis. Members' incomes in a cooperative should be determined either according to the amount of work they contributed, or according to their financial contribution to the cooperative. Cooperative members could provide income from their cooperatives in return for their workforce contribution or financial contribution to the cooperative. If they so agreed, cooperatives could also issue shares for sale to members at a fixed rate of return which was not necessarily to be governed by the cooperative's actual performance. Cooperative shares could not be sold to non-members. Cooperatives could employ non-members on a temporary contract basis for a fixed payment.

- A council of members who would elect a chairperson should decide upon cooperative business. Contract workers would not have a vote and would not be considered as members of the cooperative. Cooperatives would be managed by a chairperson who would be elected by a council of cooperative members. Contract workers would not be considered as members of the cooperative, and would not have a vote in the election.



Gorbachev sought to establish cooperatives as clearly socialist organizations, based mainly on the labor of their members and characterized by democratic management. Exploitation via wage labor was not permitted in the cooperatives.

In practice, under this cooperative law, a cooperative member could take a high income from his/her financial contribution in return for only a small proportion of their labor to a cooperative. Furthermore, since contract workers were only paid a fixed contract price for their services they would not be able to share in any extra profits that might result from their work for a cooperative. The importance of cooperatives was stemming from their being the first example of a private enterprise form on a larger scale than individual self employment or family business.

Cooperatives experienced a fast rise and fall in a two years time. Unlike the previous attempts of economic reform, the branch ministries did not see their own interests so adversely affected by this law regarding cooperatives that they did not seem to take such an active part in the discussion process of this law.<sup>133</sup>

### **3.5.2 Political Situation and the Reform Debates**

Towards the end of the 1980s, a conservative opposition from the Party cadres at different levels began and not surprisingly ministry officials were also affected by this development. Though Gorbachev made many appointments from the reformist figures to consolidate his reform attempts in the beginning of his administration, this could not prevent an open struggle within the *nomenklatura*.<sup>134</sup> At the same time, conservatives, generally from the *Gosplan* and other central organs desired to take part in the reform commissions in order to control the reform attempts in this period.

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<sup>133</sup> *Ibid.*, p. 86.

<sup>134</sup> Sakwa, *op cit.*, p. 13.

In such an environment, Gorbachev also initiated revolutionary changes in the political system. A new legislative organ was established: the Congress of People's Deputies.<sup>135</sup> Gorbachev's aim was to shift the balance of power from the Party and economic ministries to people. Thus, Gorbachev tried to establish a more democratic structure compatible with the innovations in production relations such as enhancing self-management in enterprises in favor of workers. Another aim of Gorbachev was the elimination of the CPSU from all its direct administrative powers.<sup>136</sup>

Congress of People's Deputies was elected for the first time by competitive elections in March 1989. In this election, many well known reformers such as Bogomolov, Gavriil Popov, Shmelev became members of the Congress.<sup>137</sup> However, communists who had strong connections with the ministerial bureaucracy or conservative section of the Party still dominated the new Congress of People's Deputies, with 87 per cent.<sup>138</sup>

In this political atmosphere, Gorbachev administration continued to introduce reforms in production relations in favor of the workers.

### **3.5.3 Law on Leaseholding**

This law was implemented initially in the agricultural area. Gorbachev in a series of speeches in late 1988 and 1989 called for adjustments to be made in the production relations in agriculture, arguing for a campaign to attract people in forming leasing and contracting work collectives. He thought that leasing would help foster a feeling of ownership over land or livestock, which would ensure a greater sense of responsibility. He also argued that if the period of lease holding was extended to fifty or even one hundred years, this could

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<sup>135</sup> Walker, *op cit.*, p. 122.

<sup>136</sup> Bedirhanoğlu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenklatura in the Neoliberal Era*, p. 141.

<sup>137</sup> Cox, *op cit.*, p. 104.

<sup>138</sup> Sakwa, *op cit.*, p. 138.

encourage leaseholders to feel free to invest in improvements to their land or stock due to the long term benefits to their families.<sup>139</sup> Gorbachev also proposed the idea that leaseholding should be extended to the industrial area and trade.

In this context, it should be mentioned that, a few leasing arrangements were already adopted by some enterprises in Moscow as early as 1987. Some of the new cooperatives and individual enterprises, for example in catering and the retail trade, had involved in leasing premises or equipment from the state. At that time, even though there were some legal bases for lease holding, the reform faced a number of constraints. At the enterprise level, there was an overwhelming resistance from the managers and Party officials<sup>140</sup> and not surprisingly they got an influential support from the conservative cadres.

The first legislation attempt about leaseholding was a decree clarifying the rights in both collective farms and state enterprises in April 1989. Thus, leasing of industrial units to teams of workers began in 1989.<sup>141</sup> According to this decree, work teams could sign contracts with their workplace to lease land, equipment, or premises for some periods. This decree also extended lease periods by suggesting an upper fifty years, and sometimes more. On the other hand, this decree left the decision of whether to lease or not to the enterprise or governmental body that held rights over the property in question.<sup>142</sup>

Because of the volatile political conditions, Law on Leasehold was approved for implementation at the beginning of 1990, after it was debated in the Supreme Soviet in November 1990.<sup>143</sup>

This law gave the work collectives a comprehensive authority over the enterprises. It provided all employees with a right for a general meeting to set

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<sup>139</sup> *Ibid.*, p. 106.

<sup>140</sup> *Ibid.*, p. 107.

<sup>141</sup> Ruthland, *op cit.* p. 213.

<sup>142</sup> Cox, *op cit.*, p. 108.

<sup>143</sup> Sakwa, *op cit.*, p. 281.

up an organization with the purpose of drawing up a draft lease. This draft lease had to be prepared in consultation with the trade union and submitted to the ministry as the owner. After an agreement was reached, the enterprise would operate under a management responsible for the work collective.<sup>144</sup>

At the same time, according to this law, a leased enterprise was free to enter into contracts with other suppliers or customers. It could also issue securities and payment of dividends. Additionally, this law allowed a leased enterprise to determine its own wage rates and system of payment.<sup>145</sup>

The Law on Leaseholding obviously opened a new stage in the legislation of *perestroika*, which was related to property relations in the Soviet Union. What was significant about this law was that it permitted the inheritance of individual and family leases by family members in the case of the death of the original leaseholder, which was a totally new understanding in Soviet system.<sup>146</sup>

A particular innovation of the new law was that it gave greater freedom of operation within the state sector for the first time. It suggested more favorable tax rates for managers, and also allowed them a degree of freedom in setting wages and work routines. Thus, on balance, although the leased holding reform offered many advantages to leased enterprises and their workforce in determining production conditions, it ultimately confronted a traditional set of barriers stemming from the vested interest of state enterprise managers and ministry officials.<sup>147</sup>

### **3.6 Ownership Debate and Laws on Property**

Law on Leaseholding paved the way for an extensive debate on the question of ownership in the USSR. According to Block, there were four

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<sup>144</sup> Cox, *op cit.*, p. 109.

<sup>145</sup> *Ibid.*

<sup>146</sup> *Ibid.*, p. 110.

<sup>147</sup> *Ibid.*, p. 111.

groups supporting different views. The first one was the conservative group, who believed that ownership was equal to political power, and political power should remain in the hands of the state. The second one, neo-conservatives, believed that there was nothing inherently wrong with state ownership, while asserting that problems arose because state ownership had been deformed. They saw democratization as a remedy for the problems. The third group, moderates, favored a limited depolitization of ownership. They wanted to define socialism as a system that was based on diversity of forms of ownership. And the fourth one was the radical group who saw the “property of all the people” as an ideological fiction. They clearly supported the necessity of private property as the main ownership form.<sup>148</sup>

### **3.6.1 The USSR Law on Ownership and Legislations Concerning Property**

Within the framework of the ownership discussions, the Law on Property was adopted on March 6, and took effect in July 1990.<sup>149</sup> This law removed the hierarchy of ownership among the state, co-operative and individual properties and strongly suggested that all forms of ownership are equal.<sup>150</sup> This law also expanded the limits of individual ownership, and allowed ownership of the means of production for the labor-based business.

Additionally, this law contained the rudiments of a program to privatize state enterprises under which privatization could take several forms. Enterprises leased under the new leasing law could be subject to redemption. Alternatively, the state could simply transfer a factory to its collective. In either case, the result was a “collective enterprise”<sup>151</sup> Another privatization type in this law was the issuing of stock. A collective could decide to transform its

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<sup>148</sup> Block, *op cit*, p. 5-12.

<sup>149</sup> Sakwa, *op cit*, p. 309.

<sup>150</sup> Block, *op cit*, p. 12.

<sup>151</sup> *Ibid.*, p. 14.

enterprise into a stock company, but only if its ministry would agree. Stockholders could include individuals as well as institutions; they could even include individuals who did not work at the related plant.<sup>152</sup>

In fact, this law also contained some contradictions like providing the bureaucracy with a controlling power over their implementation. While this law granted property holders with the right to hire their labor, the law prohibited “the exploitation of man by man”.<sup>153</sup> Similarly, although it legalized the ownership of the means of production by the ‘citizens’, the national and republican authorities were empowered by the right of determination of the types of property, which could not be owned by citizens.<sup>154</sup>

In addition to Law on Property, the government proclaimed a decree clarifying conditions for the transformation of state enterprises into joint stock companies.<sup>155</sup> This decree arranged the terms under which joint stock companies could be set up with shares owned by different kinds of ownership including state organizations, western businesses, and both Soviet and western individual citizens.<sup>156</sup>

According to this decree, a state enterprise could turn into a closed joint stock company (JSC) during the distribution of its stock limited to its founding partners. A state enterprise could also turn into a JSC with the distribution of its stocks by open subscription. In each case the terms had to be agreed by both the work collectives of the enterprise and the supervising ministry. An implicit recognition of a form of private ownership in the USSR was the main feature of this decree.<sup>157</sup>

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<sup>152</sup> *Ibid.* p. 15.

<sup>153</sup> Clarke, “Privatization and Development Capitalism in Russia,” p. 209.

<sup>154</sup> Bedirhanoğlu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenklatura in the Neoliberal Era*, p. 146.

<sup>155</sup> Cox, *op cit.*, p. 113.

<sup>156</sup> *Ibid.*

<sup>157</sup> *Ibid.*

In August 1990, an additional legislation was proposed to allow the independent existence of small enterprises under various forms of ownership, including even the ones under the management of a single owner. According to this law, the workforce of a small enterprise should be at most 200 for industrial enterprises, 25 in the service sector enterprises. These new small enterprises could be state owned, private or cooperative; they were also given tax concession. Therefore, many managers could use the new legislation to convert their enterprises into individually owned business.<sup>158</sup> This was an indication of the enhanced power of managers over the state enterprises thanks to Gorbachev's reforms.

### **3.6.2 Political and Social Developments**

Along with the legal developments, a new body, the State Commission on Economic Reform, was established in July 1989.<sup>159</sup> Leonid Abalkin who was also promoted to the post of Deputy Prime Minister became the chairman of this commission. Abalkin prepared a long-term program for transformation to capitalism in the 1990s. His program envisaged a gradual transition to a mixed market economy. If the program was implemented, it would establish market regulation of the economy within the framework of state management, a mixture of state and collective forms of ownership. Abalkin's reform program was rejected by the Prime Minister Ryzkhov.

In such a political atmosphere, in the social field, polarization of social forces increased. The miner's strike began in the summer of 1989, with the demands related to increases in wages and changes in the working conditions in individual enterprises.<sup>160</sup> This event constituted one of the most important turning points in the rapid change of the political conditions in the country. According to Clarke, the meaning of the miner's strike was that *perestroika*

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<sup>158</sup> *Ibid.*, p. 117.

<sup>159</sup> Walker, *op cit.*, p. 196.

<sup>160</sup> Mau, *The Political History of Economic Reform in Russia, 1985-1994*, p. 56.

was no longer a matter of debate. It was resolved within the ruling stratum alone, but the aspirations of working class had also to be taken into account. Thanks to the miner's strike, it was clear that the reconstruction of the administrative command economy had become impossible, and the conviction rapidly spread within the ruling stratum that the only way forward was the transition to a fully fledged 'market economy'.<sup>161</sup> The miner's strike was also exhibited that many of Gorbachev's hitherto supporters had not agreed with him to form a democratic socialist structure. In fact, the main aim of the supporters was only to take advantage of the reform process to move upwards in the political hierarchy but nothing more. Thus, the reformist block was disintegrated because of the crucial differences between the expectations of the technocrats and the Gorbachev's close supporters.<sup>162</sup> At that point, the technocrats and bureaucrats expressed clearly their preferences in favour of capitalism that reform debates were transformed into debates over transition to capitalism.<sup>163</sup>

At this stage, radical economic programs started to dominate the political area. One of them was the 400 Days Program presented in February 1990 by a group headed by the liberal economist Grigorii Yavlinsky. Another one was the 500 Days Program prepared by a team under the direction of Shatalin who was supported by Yeltsin in August 1990. And the last one was the Yavlinski-Allison Plan in June 1991. All of these programs aimed at rapid transition to a market economy and large scale privatization of the state owned enterprises.<sup>164</sup>

In such a rapidly changing political atmosphere in favour of the capitalist option, Gorbachev chose the middle way between capitalism and socialism. Gorbachev presented his own proposals in a paper, titled 'Basic

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<sup>161</sup> Clarke, "The Crisis of The Soviet System," p. 48.

<sup>162</sup> Bedirhanoğlu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenklatura in the Neoliberal Era*, p. 149.

<sup>163</sup> Clarke, "The Crisis of The Soviet System," p. 48.

<sup>164</sup> Cox, *op cit.*, p. 122-4.



Guidelines', which was approved by the Supreme Soviet in October 1990. Gorbachev's program did not envisage to harden the authority of ministries to issue state orders. According to his program, the final destination of the property reform would involve a privatization process that would hough take a much longer period than had been envisaged by Shatalin.<sup>165</sup>

This political development in fact indicated that the reforms had gone beyond Gorbachev's aim of introducing market regulation into a system based on collective forms of ownership. At the same time, this program also gave the decision-making authority over the disposal of state property to the republics. According to this program, Union Republics could also determine the details of privatization. Hence, the Soviet state lost its controlling power over the destatization and privatization.

After this stage, radical liberals quickly acquired a popularity in the political area. The process of the rise of popularity of the radical liberals had started firstly with the miner's strike in 1989. The radical liberals also presented themselves as the representatives of the general interest.<sup>166</sup> The election for the Congress of People's Deputies in 1990 was another important opportunity for radical liberals to broaden their popularity.

The well-known conservative August coup against Gorbachev, was the decisive event for radical liberals to consolidate their control power in the course of change. Conservatives felt that Gorbachev's reform program had gone too far and the proposed union treaty dispersed too much of the central government's power to the republics.<sup>167</sup> Therefore, they aimed to oust Gorbachev and take control of the country on August 19, 1991.

The leaders of the August coup formed the Committee of the State of Emergency and attempted to assume control of the government. However,

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<sup>165</sup> *Ibid.*, p. 124.

<sup>166</sup> Bedirhanoğlu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenklatura in the Neoliberal Era*, p. 155.

<sup>167</sup> Christopher Cox, *Russia's Road to Corruption*, chapter 4, pp. 68-93, p. 72, <<http://policy.house.gov/russia/ch4.html>>

Russian parliamentarians, under the leadership of Yeltsin, led popular resistance to the Committee's leadership and the August coup collapsed in only three days. The August Coup crushed Gorbachev's hopes that the union could be held together in at least a decentralized form and hastened the disintegration of the Soviet Union. Moreover, political power in Russia had devolved to Yeltsin, who used the coup's failure to eliminate the political power of the conservatives.<sup>168</sup>

After the August coup, the USSR lived for only a few months. Gorbachev and his reform attempts took their parts in history, and Yeltsin and his radical reformist team started to direct Russian politics.

### **3.6.3 The Establishment of the Russian Republic**

In June 1990, Russian Soviet Federal Socialist Republic (RSFSR) declared its sovereignty.<sup>169</sup> This event initiated a new stage for *nomenklatura* that enjoyed many opportunities of the rapid change towards capitalism in the RSFSR.<sup>170</sup> At the same time, the radical liberals gave up their announced target of democratizing the USSR, replacing it with the aim to ensure the national sovereignty of Russia against the USSR.<sup>171</sup>

Yeltsin, as a sign of his radicalism, declared his support for the Shatalin Program that deemed privatization the core of his program. Afterwards, in November 1990, the Russian Supreme Soviet declared its right of jurisdiction over all property in the Russian territory, and in the next few months it rapidly adopted its own new laws on property, enterprises, and land instead of the

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<sup>168</sup> "Soviet Coup Attempt of 1991," The Columbia Electronic Encyclopedia, Sixth Edition, Columbia University Press, 2003, August 30, 2005.  
[http://www.answers.com/august\\_coup](http://www.answers.com/august_coup)

<sup>169</sup> Walker, *op cit.*, p. 180.

<sup>170</sup> Bedirhanoğlu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenklatura in the Neoliberal Er*, p. 153.

<sup>171</sup> *Ibid.*, p. 160.

corresponding Soviet laws.<sup>172</sup> These laws were more radical than Soviet property laws.

On December 24, 1990, the Republic's Supreme Soviet passed the Law on Ownership in the RSFSR, which became effective in January of the next year. This law provided that the ownership in Russia would be regulated by the republic, not by the all-union law. This law contained a broader definition of property than its all-union counterpart. It encompassed not only land, buildings, securities, and the like, but also enterprises, minerals, raw materials, and "other property for productive, consumptive, social, cultural, or many other purposes."<sup>173</sup> Like the USSR Law on Ownership, the RSFSR Law abandoned the distinction between socialist and non-socialist ownerships and substantially modified the traditional categories of state, personal, and collective property. Most significantly, it recognized private property, which the USSR law pointedly failed to do.<sup>174</sup> Hence, this law departed significantly from the USSR Law on Ownership in defining and regulating state property. It acknowledged the division between republican and local authorities in state property. Republican holdings were characterized as "federal property," while the holdings of cities and regional entities were described as "municipal property". The state vested the ownership of municipal property to local soviets and to other organs of local self-government. Local authorities became "independent owners" of their property without any responsibility to the republican authorities.<sup>175</sup>

Along with this law, a new law on enterprise organization, "Law on Enterprises and Entrepreneurial Activity," recognized enterprises in all kinds of ownership. This law was clearly different from the Soviet legislation in its treatment of state enterprises. The Russian Law gave a role to the employees in

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<sup>172</sup> Cox, *op cit*, p. 125.

<sup>173</sup> Block, *op cit.*, p. 17.

<sup>174</sup> *Ibid.*, p. 18.

<sup>175</sup> *Ibid.*, p. 20.

decisions, which would affect their work organization. However, this law was not clear about the balance of power in the state enterprises between work collectives and the relevant branch ministries.<sup>176</sup>

Throughout 1991, the Russian government sought to implement a program that envisaged the distribution of state property to other forms of ownership. In this regard, a new legislation on privatization of state property was adopted. The details of the Russian legislation about privatization will be examined in the next chapter.

### **3.7 Conclusion**

This chapter examined six years of the USSR under the Gorbachev administration. As discussed, Gorbachev, who was determined to introduce reforms at all costs in the Soviet Union, had gradually moved toward radical initiatives. What forced Gorbachev to this direction was the conservative resistance of the Soviet *nomenklatura* against reforms who felt threatened by the reformist wave.

This uncontrolled move towards radical changes brought about the end of the USSR, but not the end of the rule of the *nomenklatura* as will be discussed in the next chapter. The Soviet *nomenklatura* would prove its power in the system by successfully manipulating the process of transition to capitalism in the Russian Federation and transforming itself to the new Russian bourgeoisie.

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<sup>176</sup> Cox, *op cit.*, p. 126.

## CHAPTER 4

### MASS PRIVATIZATIONS

#### 4.1. Introduction

Following the collapse of the USSR in December 1991, a power struggle emerged between the conservative and reformist forces in Russia. President Boris Yeltsin, who was elected in June 1991, was determined to initiate a program of sweeping economic reforms. In order to transform Russia into a market economy speedily, a “shock therapy” program was adopted, and the top priorities of the economic reform program were defined as the liberalization of prices and the privatization of state enterprises. Small and medium sized state enterprises were on the agenda of the mass privatization program. In this chapter, it will be argued that although the Soviet Union collapsed as a political institution, the production relations in the former Soviet Union had continued in a different form in the new Russian Federation. To demonstrate this, the chapter will focus on the legal and institutional framework, methods, implementation and consequences of the mass privatizations in Russia, which were conducted between 1992 and 1994 for small to medium size enterprises.

#### 4.2 Legal and Institutional Framework

The Russian Voucher Privatization Program was launched on October 1, 1992 by the Decree of the President of the Russian Federation.<sup>177</sup> In fact, regarding the privatization efforts, the Russian Supreme Soviet had already passed two relevant laws; one on the Privatization of State and Municipal Enterprises in the Russian Federation, and the other on the Personal

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<sup>177</sup> Wladyslaw, Jermakowicz, Julian, Pankov Aleksander J., Abramov, “Voucher Privatization in Russia: First Results and Experiences,” Center for Social and Economic Research, Warsaw, 1994, pp. 1-47, p. 1.

Privatization Accounts in the summer of 1991, shortly after the election of Boris Yeltsin as the President of the Russian Republic.<sup>178</sup>

The law “On Privatization of the State and Municipal Enterprises in the RSFSR” was adopted on July 3, 1991. Article 1 of this law spelled out that privatization was “an acquisition by citizens, joint-stock companies (partnerships) of various forms of property (as it is provided by the law) from the state and from the local Soviets of the People's Deputies as private property”. According to the Law, the share of the state, local Soviet, or public organization, or charitable fund in a privatized enterprise should be limited to 25 per cent, and the shares of the enterprises should be privatized through auction sale or sale through a tender by providing certain benefits for the workers.<sup>179</sup> This law also established that government should submit to the legislature an annual program specifying what would and what would not be divested, and in what manner. It also assigned enterprise managements some responsibilities in the process of privatization that there appeared to be a substantial overlap of responsibilities. It gave enterprise workers the power to approve or reject, or at least delay, privatization proposals, but said only very little about foreign investment and ownership.<sup>180</sup> The second law was not a detailed one; it only vaguely indicated that investment certificates would be distributed to all citizens to be used in the privatization process.<sup>181</sup>

On October 28, 1991 President Yeltsin clearly declared his intention to undertake a radical market economic reform in a speech made to the Russian Congress of People's Deputies. Later Yeltsin appointed a new type of government, and almost all old Soviet branch ministries were abolished. The

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<sup>178</sup> Stefan Hedlund, “Property without Rights: Dimensions of Russian Privatization,” *Europe-Asia Studies*, March 2001, pp. 1-24, p. 14 and Anders Aslund, “Why Has Russia's Economic Transformation Been So Arduous?” *Paper presented at the World Bank?Annual Bank Conference on Development Economics*, Washington, D.C., April 28-30, 1999, pp. 1-59, p. 2.

<sup>179</sup> John Nellis, “The World Bank, Privatization and Enterprise Reform in Transition Economies: A Retrospective Analysis,” Center for Global Development, The World Bank, 2002, pp. 1-62, p. 33.

<sup>180</sup> *Ibid.*

<sup>181</sup> *Ibid.*

new ministers of Yeltsin were outsiders, liberal economists led by Prime Minister Yegor Gaidar.<sup>182</sup>

Moreover, a decree on December 29, 1991, which set out the basic rules for privatizing state enterprises in the Russian Federation, followed only four days after the resignation of Mikhail Gorbachev from his post as Soviet President.<sup>183</sup>

By April 1992 a mass privatization program had been defined, clarified by the new executive body and submitted to the legislature. According to this program, vouchers were the centerpieces. A final version of the first privatization program for the state-owned and municipal enterprises were adopted by a decree of the Supreme Soviet of the Russian Federation only on June 11, 1992. Finally, after a series of delays, the Russian mass privatization program was launched on October 1, 1992 by the decree of the President of the Russian Federation, under the Gaidar government.

Responsibility for implementing the privatization program was vested in two separate bodies. The administrative and bureaucratic aspects of privatization were given to the State Property Committee of the RSFSR (*Goskomimushchestvo*, GKI) within the framework of the government.<sup>184</sup> In fact, the GKI had already been established in July 1990 in order to supervise the distribution of property between the Soviet Union and the then RSFSR. Its first post-Soviet chairman was Anatoli Chubais, who in June 1992 was also appointed Vice-Premier.<sup>185</sup> The second institution was the Russian Fund of the Federal Property (RFFP) which had a function related to actual selling or holding property. The dualism between these two bodies reinforced the

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<sup>182</sup> Aslund, "Why Has Russia's Economic Transformation Been So Arduous?," p.3.

<sup>183</sup> Hedlund, *op cit*, p. 14.

<sup>184</sup> Alexander Radygin, "The Mass Privatization and The Voucher System," Center For Social and Economic Research, Warsaw, 1996, pp. 18-39, p. 19.

<sup>185</sup> Hedlund, *op cit*, p. 14.

confrontation at all levels of authority between the legislative and executive organs in 1991-1993.<sup>186</sup>

While these two bodies were official organs of the Russian Federation, there also emerged a third body, the Russian Privatization Center (RPC), the status of which was deliberately vague. On the one hand, it attracted grants from foreign donor agencies as a non-profit organization. On the other hand, it arranged meetings with representatives of foreign governments and international financial organizations like the IMF just like a Russian government agency. It also tried to impact government policies by appearing as a representative of foreign creditors and grant-giving bodies.<sup>187</sup>

### **4.3 Expected Results of the Mass Privatizations**

The Gaidar government expected several results out of mass privatizations:<sup>188</sup>

- (1) Emergence of a socially oriented market economy on the basis of the formation of the category of private owners;
- (2) Enhancement the efficiency of enterprises;
- (3) Social infrastructure development by using the gains from the privatization;
- (4) Contribution to financial stabilization;
- (5) Contribution to the establishment of a competitive market structure;
- (6) Attraction of foreign investors.

Yeltsin also proclaimed that the principal objective of the voucher program was to distribute state property to the citizens. At the outset of the voucher privatization initiative, he asserted that “We don't need a few millionaires, we need millions of owners.”<sup>189</sup>

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<sup>186</sup> Radygin, “The Mass Privatization and The Voucher System,” p. 18.

<sup>187</sup> Hedlund, *op cit.*, p.14.

<sup>188</sup> Andrei Shleifer and Maxim Boycko, *The Politics of Russian Privatization*, In Olivier Blanchard *et al.*, *Post-Communist Reform: Pain and Progress*, Cambridge MA: MIT Press, pp.133-163, p. 158.

<sup>189</sup> Sheleifer and Boycko, *op cit*, p. 155.



This program was envisaged as the fastest privatization in human history.<sup>190</sup> As people owned state assets as fast as possible, government had expected to increase the political support for privatization and reform in general.<sup>191</sup> At the same time, this program was a way to make money for government by bringing in revenue from the sales and reducing the state's financial obligations to inefficient enterprises.<sup>192</sup>

#### **4.4 Methods of Privatization**

All state owned enterprises were divided into three categories according to the method of privatization used<sup>193</sup>:

- Small businesses, which had an average workforce of up to 200 employees and book value of their fixed capital less than 1 million rubles as of 1 January, 1992 would be sold at auctions and tenders.<sup>194</sup>

- Large-size enterprises which had an average workforce more than 1,000 employees or book value of their fixed capital of more than 50 million rubles as of 1 January, 1992 would be privatized by being transformed into open joint -stock companies;

- The remaining enterprises would be sold by any method set in the program.

##### **4.4.1 Reasons for a Voucher Program**

The voucher privatization program was a compromise in Russia's mass privatization program. There were several reasons to privatize 240,000 state-

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<sup>190</sup> Richard Layard, "The Fastest Privatization in Human History," *Financial Times*, October 6, 1993.

<sup>191</sup> Jermakoviez *et al.*, *op cit*, p.1-2.

<sup>192</sup> Pinar Bedirhanoğlu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenklatura in the Neoliberal Era*, p. 179.

<sup>193</sup> Radygin, "The Mass Privatization and The Voucher System," p. 22.

<sup>194</sup> 81 thousand small-scale enterprises like stores and repair shops were privatized for cash from the beginning of 1992 to the end of August through public auctions.

owned and municipal enterprises through vouchers, and the most important of these were that people were short of money to buy the shares of the enterprises and Russian enterprises which were in need of high technological innovation and investment were not attractive for foreign investors.<sup>195</sup>

Under these conditions, it was firstly assumed that the vouchers would generate a demand for shares in the privatized enterprises. The population's savings were far too low to buy more than a fraction of state-owned asset; the capacity of Russia's newly developed private business to acquire privatized enterprises was also limited; and foreign investor's participation was low because of the lack of political stability, the sad condition of Soviet technology, and unclear legal environment surrounding foreign direct investment in Russia. Thus vouchers, it was expected, would make an additional demand for state property.<sup>196</sup>

Secondly, it was hoped that the vouchers would ensure fairness of the privatization process. All Russian citizens, not just enterprise workers, managers and old *nomenclatura*, would benefit from the process.<sup>197</sup>

It was thirdly assumed that the program would create a new economy with entrepreneurial owners and efficient enterprises. In fact, the architects of voucher privatization program acknowledged that the reallocation of property rights to efficient owners were to be established later, following the redistribution of state assets equally to the people through vouchers.<sup>198</sup>

#### **4.4.2 Features of Vouchers**

In line with the program, the Russian government distributed the vouchers to each of the citizens of the Russian Federation, regardless of their

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<sup>195</sup> Hedlund, *op cit*, p.16.

<sup>196</sup> Jermakoviez, et al., *op cit*, p.1.

<sup>197</sup> *Ibid*, p.2.

<sup>198</sup> Nelson and Kuzes, *op cit*, p. 125-6.

age, residence, place of employment, or level of income.<sup>199</sup> Vouchers began to be issued on October 1, 1992, and the whole process was finished on March 31, 1993.<sup>200</sup> Subsequently, 144 million privatization “vouchers” were distributed to the people.<sup>201</sup>

Vouchers were freely circulating securities, which were not issued on names and replaced if lost or stolen. They were transferable and have a specified validity period. The government guaranteed that vouchers issued in 1992 could be used as a means of payment when purchasing shares of enterprises at voucher auctions. The government did not guarantee a cash value for vouchers.<sup>202</sup> It was also guaranteed that people could sell or invest them as specially created “voucher investment funds”.<sup>203</sup>

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<sup>199</sup> Paul Hare and Alexander Muravyev, “Privatization In Russia”, Russian-European Centre for Economic Policy Research Paper Series, August 2002, pp. 1-25, p. 3.

<sup>200</sup> Jermakoviez *et al.*, *op cit*, p.9.

<sup>201</sup> Leon Aron, “The Strange Case of Russian Capitalism,” *Russian Outlook*, American Enterprise Institute for Public Policy Research, Winter 1998, pp. 1-14, p. 1.

<sup>202</sup> Jermakoviez *et al.*, *op cit*, p.9.

<sup>203</sup> An important role in the Russian voucher privatization program was played by the Voucher Investment Funds (VIFs). They intended to accumulate vouchers, licensed and regulated by the *GKI* and local committees. VIFs were closed-end funds organized as joint stock companies (JSC). This means that shareholders could not demand that the fund redeem their shares, but the Fund shares had to be tradable. The requirements for establishing a VIF were relatively easy to meet, allowing any citizen or institution the opportunity to establish one. The role of the fund was to make profit for investors by buying JSC shares at special voucher auctions, by investing directly in shares, through the secondary markets and/or by trading in vouchers - accumulating them and selling them on to investors. Funds made profits for their shareholders in three ways: by accumulating dividends paid to them out of the annual profits of JSCs whose shares they own, by selling shares of the companies, and by selling vouchers at a price higher than their purchase price. An interesting phenomenon was that the funds were most often acquiring shares in a manner not always fully clean and legal. Another one was a lack of control by shareholders. According to the Presidential Decree no. 1186, funds were to organize annual shareholders meetings, at which decisions regarding the division of profits are to be made. It was also mandatory to maintain a quorum, such as that at least half the shareholders are to be present at the meeting. These regulations, however, were impossible to enforce. So the funds became sources of corruption in Russia in a short period of time. For more details look at Wladyslaw, Jermakoviez, Julian, Pankov Aleksander J., Abramov, “Voucher Privatization in Russia: First Results and Experiences,” Center for Social and Economic Research, Warsaw, 1994, p.31-38.

A voucher holder could use his voucher in one of the three ways: to buy shares of privatized enterprises in auctions or tenders, to exchange it for shares in mutual funds, or to sell it for cash. Because of the last option, a secondary market for vouchers emerged where vouchers could freely be sold or purchased.<sup>204</sup>

#### **4.4.3 Privatization Process of an Enterprise**

Privatization of each enterprise started with the development of a privatization plan which determined the procedures for the sale of shares as well as the proportions offered to various groups of potential investors; most importantly, employees and managers within the limits allowed in the privatization regulations. The plan was to be approved by the GKI or its regional offices.<sup>205</sup>

In the next stage, state enterprises transformed into open joint-stock companies wholly owned by the state. At this stage the charter capital of each firm was calculated as the book value of its assets other than land and net value of any outstanding debt. Then, the board of directors was appointed comprising the general manager with two votes, a representative of rank-and-file employees, and one representative each from the federal and local governments. Shares of newly created companies were transferred to the RFFP with its regional branches, which acted as the sellers of enterprises.<sup>206</sup>

Given the generous entitlements offered to managers and employees in the Russian privatization, these insiders were able to choose from the three options at a general meeting of their enterprise.

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<sup>204</sup> Jermakoviez *et al.*, *op cit.*, p.13.

<sup>205</sup> Hare and Muravyev, *op cit.*, p. 3.

<sup>206</sup> *Ibid.*

## **4.5 Rounds of Voucher Privatization**

The main political problem during the preparation process of privatization was the question of satisfying the interests of all partners taking part in the privatization: employees, managers, citizens and potential strategic investors. Therefore, a very rigid procedure of shares distribution was introduced in the program. This procedure assumed three rounds: closed subscription round, voucher auctions round, and investment tenders round.<sup>207</sup>

### **4.5.1 The First Round: Closed Subscription**

In the first round, the interests of managers and employees were secured and the insider distribution of vouchers took place according to the options explained below.

Option 1: 25 percent of the shares of newly commercialized firms were given to employees as preferred stock for free. A limitation, however, applied here: the total number of shares distributed free to employees could not be higher than 20 times the legally guaranteed monthly minimum wage per employee. In November 1992, it amounted to 20 thousand rubles, in other words, 20 shares per employee.<sup>208</sup>

In addition to the 25 percent of free distributed shares in this variant, a further 10 percent of shares could be sold to employees at a 30 percent discount of the January 1992 book value.<sup>209</sup> By this way, the employees could acquire 10 percent of all shares by paying only 70 percent of their issue value. Moreover, senior enterprise managers could purchase an additional 5 percent of the stock in the form of ordinary shares.<sup>210</sup>

Option 2: Workers and managers could buy - for cash or vouchers - 51 percent of voting shares at 1.7 times of the book value of the enterprise on

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<sup>207</sup> Jermakoviez, et al., *op cit*, p. 2.

<sup>208</sup> *Ibid*, p.3.

<sup>209</sup> Hare and Muravyev, *op cit*. p. 4.

<sup>210</sup> *Ibid*.

January 1992.<sup>211</sup> An approval by 2/3 of the employees was required. There were no free shares and no preferential discount under this option, and participants must, according to Russian law, pay with vouchers for 50 percent of their shares (100 percent of the payment in vouchers was encouraged). Additionally, to make the whole process more difficult, the entire payment must be made within 90 days.<sup>212</sup>

Option 3: A managing group (that could include existing management and workers, or any other physical or legal person) that took responsibility for the execution of the privatization plan and the prevention of enterprise bankruptcy could buy 30 percent of the voting shares; a further 20 percent could be purchased by management and workers (regardless of whether they were part of the managing group) at a 30 percent discount.<sup>213</sup> Only 1.5 percent of the firms adopted this variant and it played a marginal role in the voucher privatization.<sup>214</sup>

Option 1 was first proposed as the main approach, but it met with strong resistance from the managers that Russian government lacked the capacity to force this method of privatization on unwilling managers.<sup>215</sup> The second and the third variants were introduced under the political pressure of workers and management lobbies through regional leaders and through their representatives in the Russian Parliament.<sup>216</sup>

#### **4.5.2 The Second Round: Voucher Auctions**

In the second round, shares unsold in the first step would be sold at organized auctions where voucher holders (individuals, mutual funds, or

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<sup>211</sup> *Ibid*, p.2.

<sup>212</sup> Jermakoviez *et al.*, *op cit*, p.3.

<sup>213</sup> Hare and Muravyev, *op cit*, p. 5.

<sup>214</sup> Jermakoviez *et al.*, *op cit*, p.4.

<sup>215</sup> Bernard Black, Reinier Kraakman, Anna Tarassova, "Russian Privatization and Corporate Governance: What Went Wrong?," *52 Stanford Law Review*, 2000, pp. 1731-1808, p. 1740.

<sup>216</sup> Jermakoviez *et al.*, *op cit*, p. 4.

venture capital companies) purchase them at market price. Local State Property Funds organized the voucher auctions.

The number of shares presented at auctions is determined as the difference between the total number of shares and the number of shares allocated at closed subscriptions. Moreover, a minimum 20 percent of shares had to be distributed for cash among strategic investors (to finance the whole operation). Therefore, not all of the issued shares could be available at the organized exchanges (voucher auctions). Because 25 percent of the shares were divided among employees and 20 percent should be designated for the third round, 55 percent of the remaining shares was the one that could be distributed through voucher auctions in the first variant, if employees and management refused the option to acquire the 15 percent of their reserved shares. In the second variant, after distributing 51 percent in the first round, no more than 29 percent of shares could be available to the outside investors. During the two first rounds, however, no more than 80 percent of all shares could be sold.<sup>217</sup>

#### **4.5.3 The Third Round: Investment Tenders**

In the third round, shares unsold at the auctions could be sold through direct sale to potential strategic investors. Decisions about who could buy these shares were made by the privatization funds and by firm management. It was assumed that only 20 percent of these shares could be sold by this way and in an exclusive manner for cash.<sup>218</sup>

#### **4.6 The Implementation of the Privatization Program**

Gaidar and his ministers, as liberal economists, initially held the idea of sale of state enterprises with low prices to citizens.<sup>219</sup> On the other hand, the conservatives in the Russian Parliament demanded the distribution of most

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<sup>217</sup> *Ibid.*, p. 5.

<sup>218</sup> *Ibid.*

<sup>219</sup> Bedirhanoglu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenklatura in the Neoliberal Era*, p. 179.

shares to employees at almost no cost.<sup>220</sup> Industrial interests also opposed the government's privatization scheme that would make them lose all their authority over the production level. Their alternative was the insider model targeting to retain the control of enterprises with their workers and managers.<sup>221</sup>

In the process of privatization, Option 1 was the first proposed option as the main approach and the government expected that Option 1 would be the most popular.<sup>222</sup> The Russian government saw Option 2 as a political solution to convince enterprise managers and workers by giving large number of cheap shares to them.<sup>223</sup> As mentioned above, the effectiveness of owners was considered as a secondary priority for privatization, since liberals thought that even bad private owners were better than the state as owner. As Andrei Shleifer, a principal Western advisor to the Russian government, and Dmitry Vasiliev, a top Russian official responsible from privatizations, explained:

[Russian ownership] structures have been to a large extent determined by the political imperative of accommodating managerial preferences in the privatization program, since without manager support firms would have remained under political control. We believe that the ownership structures emerging from Russian privatization, while far superior to state ownership, still give managers too much control relative to what is needed to speed up efficient restructuring . . .<sup>224</sup>

The primary goal of the government was only a change in the ownership conditions of state assets regardless of responsibility. It was expected that the enterprises would be bought by responsible owners later in

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<sup>220</sup> Pekka Sutela, "Insider Privatization In Russia: Speculations On Systemic Change," *Europe-Asia Studies*, Vol. 46, Issue 3, 1994, pp. 1-14, p. 5.

<sup>221</sup> Bedirhanoğlu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenklatura in the Neoliberal Era*, p. 178.

<sup>222</sup> Sutela, *op cit*, p. 6.

<sup>223</sup> Black *et al.*, *op cit.*, p. 1741.

<sup>224</sup> *Ibid.*, p. 1742.



the secondary transactions. In practice, however, this expectation failed and the *de facto* owners of assets became the *de jure* owners of the state enterprises.<sup>225</sup>

#### **4.6.1 The Rise of Managers**

At the end of the program, majority of state firms -almost 70 percent of the firms- offered privatization Option 2 as a choice, which envisaged an insider privatization. When the workers preferred to sell their shares to their managers in time, the latter came out as the real winners of the mass privatization program.

There were several reasons for such an outcome. Firstly, an important problem was about the rapid erosion of the value of vouchers due to the high inflation and pessimist expectations of workers related to the program. The market value of a single voucher was a bottle of vodka. Via the extensive network of street kiosks, speculators managed to accumulate large blocks of vouchers, which later on would be put to good use in further strengthening insider dominance in favor of managers.<sup>226</sup>

Secondly, managers purchased directly from the employees at low prices close to nominal value in return for preserving their jobs. If the voucher prices were higher than its nominal value, managers often concealed it from the employees.

Thirdly, under the auction design, when fewer vouchers were offered to a company's shares, more shares would be distributed per voucher. This gave insiders an incentive to discourage others from bidding. There were various ways to achieve this result. The auction location could be hard to reach (Russia is a large country with limited transportation), announce or change in the last minute. In some cases, phone calls and air flights into the city where the auction took place were conveniently disrupted shortly before the auction, or armed guards excluded unwanted bidders from the auction. The more valuable the company, the more likely its managers (or well-connected outside

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<sup>225</sup> Mau, *The Political History of Economic Reform in Russia, 1985-1994*, p. 74.

<sup>226</sup> Hedlund, *op cit.*, p. 17.

investors) were to use tactics like these. And perhaps 1000 of the 15,000 mass privatized firms cut special privatization deals with the government.<sup>227</sup>

The first shareholders' meeting of the Volgograd Ceramics Factory was a typical example. This privatization gave control to the workforce as a whole. Nonetheless, the directors were usually overtly in charge. The only candidate for general director was Mikhail Shul'zhenko, the director of the factory for the past three years, and he was elected. At the same time, nine of the ten places on the board of directors ascended to the members of the firm's upper management. This kind of managerial dominance of post-privatization enterprises was not unique to Volgograd oblast. Similar events occurred in Nizhny Novgorod oblast in spite of her reformist characteristic.<sup>228</sup>

To sum up, Russian managers' personal stake in their companies was often modest to begin with, but rose quickly. As vouchers were convenient to trade with, managers bought vouchers that they could trade for shares in their own companies. They continued to accumulate shares after the voucher auctions by convincing or coercing employees to sell their shares cheaply.

#### **4.6.2 Dominance of Political Concerns**

The voucher privatization program was implemented in Russia as a political instrument to convince the stakeholders such as workers, managers, citizens, and strategic investors in the merits of privatization. Managers and workers were of course the primary target. As they resisted, the government divested to stakeholders some rents in order to obtain their support. Thus the primary feature of this privatization process was political rather than economic.<sup>229</sup>

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<sup>227</sup> Black *et.al.*, *op cit.*, p. 1741.

<sup>228</sup> Marek Dabrowski, "Two Years of Economic Reforms in Russia: Main Results", Center For Social and Economic Research, Warsaw, 1993, pp.1-17, p. 11.

<sup>229</sup> Andrei Sheleifler, and Daniel Treisman, *Without A Map*, Cambridge, Massachusetts and London, England, the MIT Press, 2000, p. 9.

The founders of voucher privatization program appeared to use symbolic values of the old Soviet system to ease adaptation of people to the new system. The victory of the Soviet Union over Nazi Germany in World War II was one of the pillars of legitimacy of the old regime. The era of voucher auctions began days after the 50th anniversary of the turning point of the war, the Soviet victory at Stalingrad - renamed Volgograd - in 1961. In the same way, the arena for the auctions, the People's Privatization Center, was in the official trade union's House of Culture, a prominent symbol of the old system located on the city's main street and taken over for this purpose.<sup>230</sup>

Compromising different interests without giving up the efficiency and upgrading concerns were hard tasks of the government. Filippov, as chairman of the Subcommittee on Privatization of the Russian Supreme Soviet at that time, argued the following<sup>231</sup>

“The most important need now is to bring in outside owners, who are interested in new opportunities and can make enterprise operations more efficient. If we permit workers to keep 51 percent of the shares of their enterprises, then those enterprises will have no chance of outside investment--either foreign or domestic. Who would want to invest their money under those conditions?”

On the other hand, Filippov also recognized that pressure from those directors who wanted to maintain the control of their enterprises could not be ignored. He explained "The interests of different layers of the population became transparent during the first stage of privatization, and the battle to satisfy these different groups quickly became more severe."<sup>232</sup>

Formally, the program would create a new economy with entrepreneurial owners and efficient enterprises. In fact, the architects of voucher privatization program acknowledged the reallocation of property rights to efficient owners were to be established later, following the redistribution of

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<sup>230</sup> Dabrowski, *op cit.*, p. 11.

<sup>231</sup> Sheleifer and Boycko, *op cit.*, p. 136.

<sup>232</sup> *Ibid.*

state assets equally to the people through vouchers.<sup>233</sup> Vasiliev admitted that, as deputy president of GKI, “Restructuring should be postponed until the completion of privatization.”<sup>234</sup> Meggison argued that one of the main causes of unsuccessful privatizations in Russia was disregard of responsible owners.<sup>235</sup> Chubais initially explained that giving away insider privatization would not create effective owners but later he admitted that; “Voucher privatization ... was a large-scale program largely of a socio-political rather than an economic character. It was a fundamental means to create the socio-political preconditions for solving economic problems.”<sup>236</sup>

#### **4.7 Consequences of the Mass Privatizations**

Quantitatively, the results of mass privatization program were extremely impressive. Firstly, within two years time the program transferred the majority of state-owned firms to private ownership, representing an unprecedented privatization effort in the world. As a result, by September 1994 there were already 100,000 privatized firms in Russia (except the agricultural sector), accounting for over 80 per cent of the industrial workforce.<sup>237</sup> Many small enterprises had been privatized, and of the 24,000 medium and large enterprises, many had been turned into corporation and over 16,462 were privatized by the end of 1994.

Secondly, the privatization program resulted in the transfer of ownership of the majority of enterprises to managers and employees. Over 70 per cent of the firms preferred Option 2 as a privatization choice, and just over

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<sup>233</sup> Bedirhanoglu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenklatura in the Neoliberal Era*, p. 180.

<sup>234</sup> Nellis, “The World Bank, Privatization and Enterprise Reform in Transition Economies: A Retrospective Analysis,” p. 43.

<sup>235</sup> William Megginson, “Privatization,” *Foreign Policy*, Spring 2000, pp. 1-8, p. 38.

<sup>236</sup> Hare and Muravyev, *op cit.*, p. 7.

<sup>237</sup> OECD, “The Russian Federation 1995,” *OECD Economic Surveys*, Paris, OECD, October 1995.

21 per cent chose Option 1 for their privatization, giving insiders - managers and workers taken together - an overwhelming degree of control.<sup>238</sup>

In terms of quality, however, the privatization program brought only a legal change in the relations of ownership. It did not clearly promote fundamental restructuring within enterprises. Most management teams remained intact. Most workers kept their old jobs.<sup>239</sup> The managers of the newly privatized enterprises had to get along with upper and lower level of productive units to save their position. For lower level, they worked out a peculiar “non-aggression pact” with workers. They promised not to reduce employment, refrain from restructuring, and not to limit production.<sup>240</sup> The managers and workers established an alliance against government and its reforms, so they, especially managers, gained many rights in this distribution process. For upper level, the existence of an enterprise in this condition could only be possible by acquiring additional subsidies from state institutions such as ministries, associations, etc. Paradoxically, privatization caused additional pressure to maintain the old hierarchical structures of managing the economy, reminding ironically the fate of Soviet reform attempts.<sup>241</sup>

Another phenomenon, trade and price liberalization policies of Gaidar government brought a competition problem as well as rising domestic prices and production costs for enterprises. This situation also kept industrial managers dependent on state organs.<sup>242</sup>

Government asserted at a press conference in December 1993 that they would gain the support of managers. When Chubais had been asked by a reporter to comment on the common perception on the directors' opposition to

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<sup>238</sup> Hare and Muravyev, *op cit.*, p. 5.

<sup>239</sup> Sheleifer and Boycko, *op cit.*, p. 151.

<sup>240</sup> Jermakoviez *et al.*, *op cit.*, p.41-2.

<sup>241</sup> *Ibid.*

<sup>242</sup> Bedirhanoğlu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenklatura in the Neoliberal Era.*, p. 185.

the current approach to privatization, his response was: “All of the directors today are on our side”. According to Boycko and Shleifer, however, the support of managers to government was restricted with 38 percent at that time.<sup>243</sup>

#### **4.8 Conclusion**

The mass privatization experience of the Russian society ended on June 30, 1994. As discussed above, in the voucher privatization program the effectiveness of owners was considered as secondary issue for privatization. It was thought that even bad private owners would be preferred to state ownership. Thus, “a change in the owners of state assets regardless of responsibility” was the main logic of these privatizations. The mass privatization program was uncompetitive and foreign investors were restricted.

The enterprise managers had *-de facto-* seized many of the rights for ownership of the former state property. Thus, these managers shaped the privatization program according to their interests. Although there were three rounds under the voucher privatization program, over 70 per cent of the firms was offered Option 2 as a privatization choice. The government had seen this option as a political solution to convince opposing managers by letting them acquire the large number of cheap shares to them. Hence, the new owners of the state assets became mostly the managers and employees. In other words, the *de facto* owners of state assets during the Soviet times became the *de jure* owners of the enterprises in the Russian Federation. Due to this reason, it can be argued that production relations in the former Soviet Union persisted in the Russian Federation extensively within the context of political relations. The distribution of state assets in the Russian Federation was carried out largely on the basis of political preferences, which was also the basis of the division of property in the Soviet system.

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<sup>243</sup> Sheleifer and Boycko, *op cit.*, p. 150.

What would the Russian government expect after this point was a post-voucher privatization program. This very issue along with the expiration of the voucher privatization program will be the subject of the next chapter.

## **CHAPTER 5**

### **CASH PRIVATIZATIONS AND SHARES FOR LOAN SCHEME**

#### **5.1 Introduction**

Following the ending of the voucher privatization program on June 30, 1994, the Russian government approved a new privatization program in which the state enterprises would be sold for cash. This post-voucher privatization program was defined as “cash privatization program”. Later in 1995, another round started in the process of privatization in Russia: shares for loan program.

Initially, general outlook of the Russian Federation in 1994 and 1995 will be briefly explained in this chapter. In these years, federal budget deficit had reached to the highest levels. The causes of this situation will also be summarized.

Afterwards, the legal framework of the cash and, shares for loan privatization programs will be explained. Shares for loan privatization program was a pledge agreement between the government and the banks in which, the banks would lend funds to the government. If the government would fail to repay the funds, the banks would have the right to sell the enterprises that they had taken as collateral. This chapter will elaborate on the implementation of the shares for loan privatization scheme due to its far reaching consequences for Russian politics: namely the rise of oligarchs.

#### **5.2 Economic and Legal Base**

##### **5.2.1 General Outlook**

In 1995, Russia was under considerable pressure from the IMF and the USA Treasury to increase tax revenues in order to meet arbitrary budget deficit targets. Rise of organized crime, the failure to enact legislation necessary for free enterprise and the war in Chechnya were undermining the Russian



government's ability to meet the aggressive tax collection goals.<sup>244</sup> In addition to this, shadow economy was huge and production figures were largely a matter of guesswork. It reduced tax collection that weakened government budget. Yury Yurkov, the head of the State Statistics Committee declared that unofficial<sup>245</sup> economy was made up of 20 percent of Russia's gross domestic product.<sup>246</sup>

Samoylenko, the President of the International Tax and Investment Center, disclosed that there were already over 300 laws in effect concerning local tax alone and each tax law was amended several times per year. Furthermore, by June 1994, tax revenues were 40 percent lower than expected due to tax evasion, which was not covered by the Criminal Code. Besides, the Russian Government initiated a program to collect back taxes from the national oil companies, which owed over 700 billion rubles to the state in October 1994.<sup>247</sup>

As the following table shows, from 1994 to 1997, tax offsets and arrears were increasing while tax collection in cash was declining.

**Table 5.1 Federal budget deficit and tax collection (percent of GDP)**

<b>Year</b>	<b>Budget Deficit</b>	<b>Total tax collection</b>	<b>Tax collection in cash</b>	<b>Tax offsets</b>	<b>Arrears owed to federal government</b>
1993	- 7.0				1.0
1994	- 10.2	7.9	7.6	0.3	1.5
1995	- 5.4	9.6	7.3	2.3	2.0

<sup>244</sup> Christopher Cox, *op cit.*, p. 84.

<sup>245</sup> To avoid tax by failing to declare incomes and revenue.

<sup>246</sup> "Shadow Sector Makes Up 20% of GDP, Report Says," *The Moscow Times*, December 7, 1994.

<sup>247</sup> Vladimir Samoylenko, "Reforming The Russian Tax System", *Russian Business Watch*, Special Edition, pp. 20-22, p. 20.

**Table 5.1 (continued)**

<b>Year</b>	<b>Budget Deficit</b>	<b>Total tax collection</b>	<b>Tax collection in cash</b>	<b>Tax offsets</b>	<b>Arrears owed to federal government</b>
1996	- 7.9	8.9	4.9	4.0	3.2
1997	- 7.0	9.6	5.9	3.6	4.0

Source: Nadezhda Ivanova and Charles Wyplosz, "Who Lost Russia in 1998," pp. 1-49, p. 42., <<http://hei.unige.ch/~wyplosz/russia.pdf>>

Tax offsets were the arrangements between the tax authorities and firms whereby firms were replacing tax payment in cash with deliveries of goods and services to the public sector. These arrangements were deceptive because no one really knew how the prices of these goods and services were set, whether they were actually in order, simply bartered, or maybe even never delivered.<sup>248</sup>

The Russian federal budget balance was gradually undermined, and on the "Black Tuesday" October 11, 1994, the exchange rate of the Russian ruble fell against the US dollar by 22 percent.<sup>249</sup> Afterwards, Anatoli Chubais was put in charge of macroeconomic policy as First Deputy Prime Minister. The Central Bank raised interest rates to 170 percent in October 1994, 180 percent in November 1994, and 200 percent in January 1995. The Russian government and the Central Bank of Russia fixed the exchange rate in a narrow band.<sup>250</sup>

The International Monetary Fund approved 12-month stand-by credit for Russian Federation in April 11, 1995 and authorized drawings up to the equivalent of 6.8 billion US dollars<sup>251</sup>. One of the key objectives of the 1995

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<sup>248</sup> Ivanova and Wyplosz, *op cit.*, p. 24.

<sup>249</sup> Graeme Gill and Roger D. Marwick, *Russia's Stillborn Democracy? From Gorbachev to Yeltsin*, Oxford, Oxford University Pres, p. 217.

<sup>250</sup> Michael S Bernstam and Alvin Rabushka, "The Emergence of a Resource-Based Monetary System, Hamstrung by the Persistence Of Ersatz Banks: 1996–1997," *Fixing Russia's Banks*, Hoover Institution.  
< <http://www.russianeconomy.org/fixingrussiasbanks/html/chapter3.html>>

<sup>251</sup> "IMF Approves Stand-by Credit for Russia," Press Release No. 95/21, International Monetary Fund, April 11, 1995.  
< <http://www.imf.org/external/np/sec/pr/1995/pr9521.htm>.>

program, which was supported by the stand-by credit was to accelerate the move to a market economy through wide-ranging structural reforms, including, in particular, measures to liberalize the trade regime and the oil sector. However, the Fund could not persistently urge the Russian government to perform this objective.<sup>252</sup>

In these years, Russians' real income had dropped to the lowest levels since the Soviet days. The government was desperately in need of liquidity, but a new IMF loan at that moment seemed impossible since Russian government's borrowing in 1995 had already soared to over 350 percent of the prior years.<sup>253</sup> The government's transactions with the IMF were represented in the following table.

**Table 5.2 Transactions with the IMF**

<b>Year</b>	<b>Total Purchases and Loans (in SDR)</b>	<b>Index (1992 = 100)</b>
1992	719,000,000	100
1993	1,078,275,000	150
1994	1,078,275,000	150
1995	3,594,250,000	500
1996	2,587,861,200	360
1997	1,467,252,800	204
1998	4,600,000,000	640
1999	471,429,000	66

Source: "Russian Federation: Transactions with the Fund from January 01, 1984 To June 30, 2005." <<http://www.imf.org/external/np/sec/pr/1995/pr9521.htm>.>

In this context, the government pursued one single predominant objective: to finance the deficit of the federal budget. Hence, the government announced a shift in priorities regarding the privatization program and the emphasis was on maximizing privatization revenues. It was thought that

<sup>252</sup> Bedirhanoğlu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenklatura in the Neoliberal Era*, p. 209.

<sup>253</sup> Cox, *Russia's Road To Corruption*, p. 84.

privatization program would yield a much-needed infusion of cash for operating needs.

## **5.2.2 Legal Framework**

### **5.2.2.1 Cash Privatization Program**

The Russian government approved a new privatization program, in which state enterprises would be sold for cash on June 30, 1994, when voucher privatization ended.<sup>254</sup> The Russian Parliament, dominated by communists,<sup>255</sup> rejected the proposed post-voucher privatization program on July 13, 1994.<sup>256</sup> However, the government saw the post-voucher privatization program as a key element that would attract investment in privatized firms.

The post-voucher privatization program was promptly promulgated by presidential decree, thus the new stage of privatization began with President Yeltsin's decree (no. 1535) on July 22, 1994, called "Basic Guidelines of the State Program of Privatization of the State and Municipal Enterprises in the Russian Federation after July 1, 1994."<sup>257</sup> This decree defined the rules governing the new stage of the privatization program.

The main goal of the new privatization scheme was announced as increasing investment in enterprises to facilitate their restructuring. Formation of a wide stratum of private owners, assistance to the establishment of strategic owners, contribution to the social protection of population and to the protection of the shareholders' rights were also defined as key objectives for the new

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<sup>254</sup> Steve Liesman, "Cabinet Approves Privatization Plan," *The Moscow Times*, July 1, 1994.

<sup>255</sup> Christopher Cox, *op cit.*, p. 82.

<sup>256</sup> Mikhail Dubik, "Duma Rejects New Government Privatization Plan," *The Moscow Times*, July 14, 1994.

<sup>257</sup> Leonid Bershidsky, "Yeltsin Decree Launches Privatization Phase 2" *The Moscow Times*, July 23, 1994.

stage.<sup>258</sup>

Within the framework of mobilization of investments into production, Black argues that although the government often required bidders in privatization auctions to promise specified future investments in the enterprise, once the winning bidder acquired the shares, the promised investments were often quietly shelved, or the shares were transferred to the supposedly good faith purchasers, who were not bound by the investment promise.<sup>259</sup>

State shareholdings in the privatized enterprises, sites of the privatized enterprises and real estate were the major objectives of privatization at the new stage. In the cash stage of the privatization scheme, three methods were envisaged: free transfer and/or sale of shares to the employees through a closed subscription, sale of equity (not less than 15-25 percent of the charter capital) through the investment tenders, commercial tenders and/or at an auction; the sale of the remaining shares at the specialized auctions including the interregional and the nation-wide auctions.<sup>260</sup>

The state enterprises were classified according to the type of the privatization methods. All the state enterprises<sup>261</sup> with the balance sheet value of fixed assets over 20 million rubles as of January 1, 1994, were to be transformed into the open JSC and privatized through the above mentioned methods. All other enterprises with the balance sheet value of their assets, less than 20 million rubles, were considered to be small seized and their shares may be sold by auctions, commercial or investment tenders.<sup>262</sup>

Procedure of sale of the specialized auctions including the interregional and the nation-wide auctions was the first technical document of the cash stage

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<sup>258</sup> Aleksandr Radygin, "Residual Divestiture Following Mass Privatization: The Case of Russia", 1996, OECD Advisory Group On Privatization. Ninth Plenary Meeting, Berlin, May 6-7, 1996, pp. 1-23, p. 4.

<sup>259</sup> Black *et al.*, *op cit.*, p. 1746.

<sup>260</sup> Radygin, "Residual Divestiture Following Mass Privatization: The Case of Russia," p. 4.

<sup>261</sup> Except for treasury enterprises, whose privatization were prohibited, enterprises with foreign interest and those for sale to the partnerships with the special preferences.

<sup>262</sup> Radygin, "Residual Divestiture Following Mass Privatization: The Case of Russia," p. 4.

privatization program.<sup>263</sup> The governmental decision (no. 438) of April 28, 1995, "On the procedure of interregional and all-Russian specialized auctions for the sale of the shares of the open JSC established by the transformation of the state (municipal) enterprises" defined the procedure for international and nation-wide specialized auctions. The decision was interesting because it included for the first time the idea of using authorized banks for the purposes of cash privatization program.<sup>264</sup>

The RFFP together with the regional funds and a number of investment institutions was set up as the Federal Stock Corporation (FSC), with the status of general agent in charge of the nation-wide and interregional auctions in February 1995.<sup>265</sup>

#### **5.2.2.2 Shares for Loan Privatization Scheme**

As mentioned before, the Russian government focused on increasing privatization revenues due to high federal budget deficit in the mid-1990s. Hence, nine private banks suggested that the government temporarily would cede its stakes in companies to be auctioned off that year to a trust, which banks would set up and manage.<sup>266</sup> The initial proposal on March 30, 1995 envisaged that the shareholdings in 43 enterprises retained in the state ownership were to be transferred to the banks in order to be held in trust for 5 years in exchange for the loan to the government which was equal to the planned budgetary revenues from privatization with the subsequent sale of shareholdings to strategic investors.<sup>267</sup> Afterwards, Finance Ministry prepared a

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<sup>263</sup> "Procedure of sales of the JSC' shares at the specialized auctions" (GKI order N2469-P of October 6, 1994).

<sup>264</sup> Radygin, "Residual Divestiture Following Mass Privatization: The Case of Russia," p. 5.

<sup>265</sup> *Ibid.*

<sup>266</sup> Black *et al.*, *op cit.*, p.1744, Hare and Muravyev, *op cit.*, p. 9.

<sup>267</sup> Elif Kaban, "Banks' Loan-for-Shares Offer," *The Moscow Times*, March 31, 1995.

plan to lend the government up to 9 trillion rubles (US dollars 1.8 billion) in exchange for control over blue-chip<sup>268</sup> state companies.<sup>269</sup>

A quarterly publication of the World Bank's Europe and Central Asia Department, "Transition Newsletter" passed the shares for loan proposal with a headline as "Deal of the Century? The Elusive Russian Bank Proposal".<sup>270</sup> It will be shown below that the "elusive proposal" only remained as a nice headline.

On the other hand, Dmitry Vasilyev, deputy chairman of the Federal Commission on Securities and Capital Markets, commented on the offer of banks as monopolistic.<sup>271</sup> Despite such criticisms, the Presidential decree (no. 478) of May 11, 1995, "On measures to guarantee the federal budget revenues from privatization" was signed by President Boris Yeltsin.<sup>272</sup> This decree directly charged the government with the task of developing the mechanism which would allow to pledge and to hand over the companies' shares in the federal ownership to legal persons for the trust management. Thus, the rules governing share for loan privatization program was defined.

Paul Hare's critique on the shares for loan privatization is that the main determinants of the shares for loan approach were the increasing uncertainty because of approaching parliamentary elections, and direct ban on privatizing enterprises in the oil industry, which had been imposed by the parliament and

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<sup>268</sup> This phrase means that stocks of a company that was considered stable and profitable and had a relatively high price per share.

<sup>269</sup> Anton Zhigulsky, "Bank Plan Gets Partial Backing," *The Moscow Times*, May 12, 1995.

<sup>270</sup> "Deal of the Century? The Elusive Russian Bank Proposal," *Transition Newsletter*, Volume 6, Number 4, April 1995.  
< <http://www.worldbank.org/transitionnewsletter/apr95/pg17.htm> >

<sup>271</sup> Elif Kaban, "Top Securities Official Blasts Consortium," *The Moscow Times*, April 22, 1995.

<sup>272</sup> Julie Tolkacheva, "Officials Say Decree To Bring Investment", *The Moscow Times*, May 13, 1995.

the aspiration of some banks' to gain control over some of the largest Russian companies as cheaply as possible.<sup>273</sup>

According to this privatization scheme, a special auction commission would decide on who would become potential participants and what would be the starting price of a shareholding (amount of loan). This privatization scheme would also set other additional conditions. Contender would submit a tender to the commission indicating the amount of the loan. Then credit agreement, pledge agreement (in exchange for the loan) and commission agreement would be signed with the winner who had offered the largest amount of the loan. Under the commission agreement, the commissioner had the right to sell the shareholding by any method except for the investment tender after September 1, 1996. Commissioner would get 30 percent of the positive difference between the sales price of shares and the amount of all the relevant liabilities and the Russian Federation budget would get the remaining amount of positive difference.<sup>274</sup>

### **5.3 The Formation of the Russian Bourgeoisie**

#### **5.3.1 Shares for Loan Auctions**

##### **5.3.1.1 Overview of the Auctions**

GKI approved 29 of the 43 enterprises, which were envisaged in the initial proposal of nine banks on March 30, 1995.<sup>275</sup> The Ministry of Fuel and Energy strongly opposed the entry of its enterprises into the shares for loan auctions. Beloretsk Metallurgical Plant fought for its exclusion from auction list with the help of the representative office of Bashkiria in Moscow.<sup>276</sup> Several lumber and wood processing enterprises such as, the Arkhangelsk

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<sup>273</sup> Hare and Muravyev, *op cit.*, p. 8.

<sup>274</sup> Radygin, "Residual Divestiture Following Mass Privatization: The Case of Russia," p. 14.

<sup>275</sup> Geoff Winestock, "Loans-for-Shares Could Prove Risky," *The Moscow Times*, October 14, 1995.

<sup>276</sup> Radygin, "Residual Divestiture Following Mass Privatization: The Case of Russia," p. 16.



paper mill, Russia's largest paper producer, sued the GKI over its inclusion in the share for loan auctions.<sup>277</sup>

The privatization word has been uttered in the defense industry under the shares for loan privatization schedule. A key long-range fighter aircraft design bureau, OKB Sukhoy Aircraft Manufacturer, and major warplane production plants, Ulan-Ude Aviation Production and Arsenyev Aviation Company, would be sold off on December 7, 1995.<sup>278</sup> Afterwards, the GKI withdrew these military industrial companies from the auctions.<sup>279</sup> In the end, twelve enterprises were excluded from the shares for loan auctions; ultimately, seventeen enterprises were offered at the auctions.<sup>280</sup>

Foreign investors were not allowed to take part in the auctions of several industrial giants, including Lukoil and Sidanko Oil Companies, Norilsk Nickel, Novorossiisk Shipping Co. and Techsnabexport.<sup>281</sup> Through these uncompetitive auctions, the *nomenklatura* would obtain the blue-chip state companies easily. Besides, the starting price of the auctions for the government shares of Lukoil, Surgutneftegaz and Sidanko Oil Companies were well below international market levels.<sup>282</sup>

However, West Siberian Metallurgical Combine, Bor, Techsnabexport, Kirovlesprom and Tuapse Sea Port auctions failed. There were no bids for West Siberian Metallurgical Combine. Bor had huge debts accompanied by the

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<sup>277</sup> Anton Zhigulsky, "Paper Mill Sues Over Inclusion In Sell-Off," *The Moscow Times*, November 14, 1995.

<sup>278</sup> Anton Zhigulsky, "Sukhoi Is Defense Sell-Off Testbed," *The Moscow Times*, November 14, 1995.

<sup>279</sup> Anton Zhigulsky, Julie Tolkacheva, "Sukhoi Removed From Loans-for-Shares Sale," *The Moscow Times*, November 29, 1995.

<sup>280</sup> Igor Baranov, Olga Patokina, "Privatization In Russia The Search for an Efficient Model," *Russian and East European Finance and Trade*, Vol. 35, No. 4, July-August 1999, pp. 30-46, p. 38.

<sup>281</sup> Anton Zhigulsky, "Strategic Sell-Offs To Exclude Foreigners," *The Moscow Times*, October 18, 1995.

<sup>282</sup> Michael Comerford, "Oil Giants' Stock Offering 'Close to Free'," *The Moscow Times*, October 19, 1995.

lack of prospects for the marketing of the pulp and paper products.<sup>283</sup> Consequently, twelve auctions took place, of which half belonged to the oil sector enterprises. All these transactions were implemented within a two-month period, from November 3, 1995 to December 28, 1995.<sup>284</sup>

### **5.3.1.2 The Crown Jewels of the Soviet Industry**

During the course of shares for loan privatization program, Russian government auctioned and sold off its shares in a number of major oil and metals companies, described as crown jewels of the Soviet industry.

The first auction under the shares for loan privatization program took place on November 3, 1995<sup>285</sup> where bidding opened on a 40.12 percent stake in Surgutneftegaz.<sup>286</sup> There were three bidders at the beginning but as the third bidder was disqualified on a technical deficiency, there remained two: an obscure company called Svift and Surgutneftegaz's pension fund. Thus, Surgutneftegaz's pension fund won the bid, pledging to pay a mere 88 million US dollars.<sup>287</sup>

In the first auction, the winner's bid was not more than the starting price of the auction. This situation was exactly the same as most of the shares for loans auctions. The next auction was for the 38 percent of Norilsk Nickel that was producing more than a quarter of the entire world's nickel and more than a quarter of the entire world's cobalt. Oneximbank was deputized to accept and evaluate bids for Norilsk Nickel auction with a starting price of 170 million US dollars, even though it was also offering a bid.<sup>288</sup> In addition, Rossiiski Kredit

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<sup>283</sup> Radygin, "Residual Divestiture Following Mass Privatization: The Case of Russia," p. 17.

<sup>284</sup> Hare and Muravyev, *op cit.*, p. 10.

<sup>285</sup> "New Loans For Shares: Bad Scheme," *The Moscow Times*, November 4, 1995.

<sup>286</sup> "The Oil Giant of Surgut, Asleep in Siberia," *The Moscow Times*, October 31, 1995.

<sup>287</sup> Bivens, Matt, Bernstein, Jonas, "The Russia You Never Met," *Demokratizatsiya*, Volume 6, Number 4, Fall 1998, pp. 613-647, p. 627.

<sup>288</sup> *Ibid.*, p. 628.

Bank offered 355 million US dollars but Oneximbank disqualified Rossiiski Kredit's bid on the grounds that the bid amount exceeded Rossiiski Kredit's statutory capital.<sup>289</sup> Oneximbank won the 38 percent stake in Norilski Nickel with a bid of 170.1 million US dollars, only 100,000 US dollars over the starting price.<sup>290</sup>

In the meantime, the Russian Parliament wanted President Boris Yeltsin to suspend the auctions under the shares for loan scheme in November 24, 1995. It was claimed that to sell off stakes in some of the country's largest companies would damage the strategic interests and national security of the Russia.<sup>291</sup> However, auctions continued. Bank Menatep auctioned 45 percent stake in Yukos as collateral for loans and tendered another 33 percent on December 8, 1995. There was a rival bid from a consortium composed of Alfa Bank, Inkombank, and Rossiisky Kredit. This consortium warned the government about the conflict of interest that Bank Menatep was the auction organizer and it was itself a bidder.<sup>292</sup> The Bank Menatep disqualified the rival bid and also the highest bid on various procedural grounds and won the bid. AOZT Laguna won Russia's second-largest oil company and control of 2 percent of the world's known oil reserves, with a total bid of 309.1 million US dollars.<sup>293</sup> AOZT Laguna was backed by the auction organizer, Bank Menatep such that the company handed over its obligations to Bank Menatep due to lack of banking license required to extend credit to the government.<sup>294</sup>

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<sup>289</sup> Black *et al*, *op cit*, p. 1744.

<sup>290</sup> Gulyayev, Michael, "Bank's Low Bid Wins Norilsk Stake," *The Moscow Times*, November 18, 1995.

<sup>291</sup> "Duma Wants Halt to Auctions," *The Moscow Times*, November 25, 1995.

<sup>292</sup> Jonas Bernstein, and Julie Tolkacheva, "3 Banks Blast Yukos Share Sale Terms," *The Moscow Times*, November 30, 1995.

<sup>293</sup> Simon Baker, "Banks Buy Control of 2 Leading Oil Firms," *The Moscow Times*, December 9, 1995.

<sup>294</sup> Julie Tolkacheva, "Yukos Winner Backed by Menatep," *The Moscow Times*, December 9, 1995.

Controlling stakes (51 percent) in Sibneft and Sidanko were also sold off. Each of them had production capacity worth 3 billion US dollars per year. Rival bids for both two auctions were disqualified for arriving twenty-four minutes late.<sup>295</sup> A consortium<sup>296</sup>, believed to represent Boris Berezovsky, won Sibneft auction for 100.3 million US dollars, although minimum bid was 100 million US dollars.<sup>297</sup> Oneximbank organized the Sidanko auction's starting price as 125 million US dollars. An affiliate of Oneximbank acquired Sidanko for 130 million US dollars.<sup>298</sup>

The shares for loan scheme ended on December 28, 1995 with auctions of the oil company Sibneft and oil trading company Nafta-Moscow. Ultimately, the auctions brought the Russian budget around 1 billion US dollars.<sup>299</sup> The privatization revenue sought by the Russian budget in 1995 was 9 trillion rubles (1.8 billion US dollars).

The results of the shares for loan auctions are represented in the following table:

**Table.5.3 Shares for Loan Auctions**

Company	Industry	Share sold (per cent)	Starting Price	Sale Amount	Purchaser
			(Millions US Dollars)		
Nafta-Moscow	Oil Distribution	15,00	16,00	20,10	Oneximbank
Sidanko	Oil extraction & processing	51,00	125,00	130,00	Oneximbank

<sup>295</sup> Anton Zhigulsky and Jonas Bernstein, "Auctions End on Contentious Note," *The Moscow Times*, December 29, 1995 and Jonas Bernstein, "Loans For The Sharks?," *The Moscow Times*, December 19, 1995.

<sup>296</sup> Stolichny Savings Bank and Oil Finance Company.

<sup>297</sup> Black et al, *op cit.*, p. 1772, and Christopher Cox, *op cit.*, p. 85.

<sup>298</sup> Christopher Cox, *op cit.*, p. 85.

<sup>299</sup> Jonas Bernstein, "Loans-for-Shares Nets \$1 Billion," *The Moscow Times*, Dec. 30, 1995.

**Table.5.3 (continued)**

Company	Industry	Share sold (per cent)	Starting Price	Sale Amount	Purchaser
			(Millions US Dollars)		
Surgutneftegaz (SNG)	Oil extraction & processing	40,12	88,00	88,00	SNG pension fund & Oneximbank
Norilsk Nickel	Mining	40,00	170,00	170,10	Oneximbank
North-West Steamship Line	Sea & River Transportation	25,50	6,00	6,10	Oneximbank
Novolipetsk Metallurgic Complex	Metallurgy	14,80	30,00	31,00	Oneximbank
Murmansk Shipping Line	Sea Transportation	23,50	4,10	4,12	Bank Menatep
Yukos	Oil extraction & processing	45,00	159,00	159,10	Bank Menatep
Sibneft	Oil extraction & processing	51,00	100,00	100,30	Stolichny Savings Bank & Oil Finance Company
Mechel	Metallurgy	15,00	5,00	13,30	Glancore International
Lukoil	Oil extraction & processing	5,00	35,00	35,10	Lukoil
Novorossiisk Shipping Company (NSC).	Sea Transportation	20,00	22,65	22,70	NSC

Source: "1988 - 1999 Privatization Transaction Data," World Bank, 2000.

<<http://www.ipanet.net/documents/WorldBank/databases/plink/soceco/1russia.htm>>

## 5.3.2 Stakeholders

### 5.3.2.1 Authorized Banking

In 1992, Prime Minister Gaidar had quietly chosen a handful of authorized banks to handle federal budget money.<sup>300</sup> Thus, in the absence of a strong treasury system, the government ensured large profits for many banks with close ties to the regime by authorizing them to manage state funds for a wide variety of government agencies.<sup>301</sup>

<sup>300</sup> Bivens and Bernstein, *op cit.*, p. 618.

<sup>301</sup> Jensen Donald, "How Russia Is Ruled 1998." <<http://www.rferl.org/specials/russia/whorules/>>

Authorized banks were supposed to receive funds from the Ministry of Finance or other government organizations and transfer the money to its intended recipients. However, with the influx of hard currency from the IMF and other Western sources, many of the bankers soon discovered that delaying those payments allowed them to use government funds to speculate on currency markets or make other short-term investments, and to keep the profits for themselves.<sup>302</sup> Therefore, authorized banks often made huge profits by delaying budget transfers so that their managers would use the money to invest in the high-yield government securities market.<sup>303</sup>

This national model of authorized banks was imitated at the local level, with the mayors of Moscow and St. Petersburg tapping their own insider banks. The banks tended to be slow in delivering the money, which because of inflation was not significant whatsoever. Sometimes they kept a hefty cut of government transactions.<sup>304</sup>

Soon, a handful of financial organizations such as Most-Bank, Gazprom, Menatep, Oneximbank, Alfa Bank, Logo Vaz and Stolichny Savings Bank came to dominate Russian political and economic life. The new elite, the owners of these Banks, grew bolder about flaunting its wealth and startlingly opening about how they earned it. One of them, Pyotr Aven of Alfa Bank candidly explained;<sup>305</sup>

To become a millionaire in our country it is not at all necessary to have a good head and specialized knowledge. Often it is enough to have active support in the government, the parliament, local power structures and law enforcement agencies. One fine day your insignificant bank is authorized, for instance, to conduct operations with budgetary funds. Or quotas are generously allotted . . . for the export of oil, timber, and gas. In other words, you are appointed a millionaire

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<sup>302</sup> Christopher Cox, *op cit.*, p. 87.

<sup>303</sup> Donald Jensen, "Russia's Financial Empires." <http://www.rferl.org/specials/russia/finance/>, January, 1998, p. 2.

<sup>304</sup> Bivens and Bernstein, *op cit.*, p. 618.

<sup>305</sup> Igor Baranovsky, "Terror is a Fact of Russian Competition," *The Moscow Times*, July 22, 1994.

Obtaining status as a favored, authorized bank was highly dependent on the political connections of the bank's management and was widely believed to have fostered corruption. In 1996, for example, the watchdog State Control Chamber found that 4.4 billion US dollars in state funds intended - though never legally budgeted - for restoration projects in Chechnya and funneled through favored commercial banks, which were wound up in the pockets of government officials.<sup>306</sup>

On the other side, in July 1995 the government declared that the ruble would not be allowed to fluctuate in value beyond the range 4,300-4,900 rubles to the US dollar. This ruble corridor limited the wild fluctuations in value which the banks had used to generate large speculative profits.<sup>307</sup> The position of the authorized banks was likely to be undermined by the creation of the Federal Treasury in 1998. In the meantime, Yeltsin ordered the government to hold open competitive bidding among the banks for government deposits, beginning from January 1, 1998. Following yet another presidential decree, the Ministry of Finance was banned from guaranteeing bank loans to enterprises.<sup>308</sup>

Eventually, authorized banks strengthened financial-industrial groups that would dominate Russian political and economic life.

### **5.3.2.2 Financial-Industrial Groups**

During the period of the Soviet regime, the main interest groups were sector-related groups. The most powerful groups were the military-industrial complex and the energy sector. Since the collapse of the regime, these alliances have been consolidating in the across sectors.<sup>309</sup>

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<sup>306</sup> Jensen, *op cit.*, p. 4.

<sup>307</sup> Gill and Marwick, *op cit.*, p. 216.

<sup>308</sup> Aron, *op cit.*, p. 9.

<sup>309</sup> Virginie Coulloudon, "Elite Groups in Russia," *Demokratizatsiya*, Volume 6, Number 3, Summer 1998, pp. 535-549, p. 541.

Deputy Defense Minister Andrei Kokoshin advocated the policy of the formation of new corporate structures that would unite design and manufacturing facilities into financial-industrial groups (FIGs), beginning in 1992. The FIGs were authorized by Presidential decree (no. 2096), which was adopted on December 5, 1993.<sup>310</sup> The intention was to integrate corporations on the pattern of South Korean *chaebols*<sup>311</sup> or Japanese *keiretsus*<sup>312</sup> to replace the Soviet centralized industrial structure.<sup>313</sup>

The Russian FIGs owed their wealth and often their origin to the political connections and the state's intervention in the economy. The Russian FIGs obtained the export licenses and arbitrated between the world market prices on oil and raw materials and the controlled domestic prices. Another source of wealth was duty-free imports, especially food, hard liquor, and cigarettes. FIG's banks were designated as authorized banks, so that the FIGs profited hugely from credits at the below-inflation interest rate before the ruble corridor.<sup>314</sup> These FIGs, were not officially registered. Such unofficial structures seemed to play a much larger role in the economy than the officially registered FIGs.<sup>315</sup>

Russian Textile Consortium was the first financial-industrial group to receive certification under the Presidential Decree No. 2096. The financial core of this first formally registered FIG was a small bank (*Doveritelnyi i Investitsionnyi Bank*). But the enterprises of the Russian Textile Consortium

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<sup>310</sup> "Military Industry Overview." <http://www.fas.org/nuke/guide/russia/industry/overview.htm>

<sup>311</sup> Korean term for a conglomerate of many companies clustered around one parent company. The companies usually hold shares in each other and are often run by one family.

<sup>312</sup> A Japanese term describing a loose conglomeration of companies organized around a single bank for their mutual benefit. The companies sometimes, but not always, own equity in each other.

<sup>313</sup> Michael Heller, Merritt Fox, "Lessons From Fiascos In Russian Corporate Governance," *Berkeley Program In Law & Economics Working Paper Series*, Paper 123, 1999, pp. 1-59, p. 54.

<sup>314</sup> Aron, *op. cit.*, p.8

<sup>315</sup> Hans Henning Schroder, "El'tsin and the Oligarchs: The Role of Financial Groups in Russian Politics between 1993 and July 1998," *Europe-Asia Studies*, Sept, 1999, pp. 1-34, p. 5.



were managed by the holding company Rosprom whose firms were centered on the Bank Menatep, ranked as Russia's tenth in assets.<sup>316</sup>

There were 39 FIGs, formally registered, incorporating more than 500 industrial enterprises and 87 financial institutions (including 37 banks) in November 1996. In addition to 39 legal FIGs, there were just as many non-official FIGs that were supposed to be registered by the state.<sup>317</sup>

Bedirhanoglu argues that although the roots of FIGs formation dates back to the early years of transition, the term Russian FIGs started to appear frequently in the academic studies and media texts after their increasingly corrupt relationship with the state became obvious. She also argues that this relationship reached its peak before the 1996 presidential elections.<sup>318</sup>

### 5.3.2.3 Oligarchs

The FIGs increased their economic and also political powers with the active support of the state and the shares for loan privatization scheme.<sup>319</sup> The new bourgeoisie who benefited from shares for loan privatization scheme was the proprietors of these selected FIGs.

An oligarchy, as discussed in Plato's *Republic* and Aristotle's *Politics*, is a form of government by a small group. In its current meaning in Russia, the term oligarch denotes a large businessman who controls sufficient resources to influence national politics.<sup>320</sup> Goldman defines "oligarchs" within the context

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<sup>316</sup> Alexei Smirnov, "Financial-Industrial Group Granted First Certification," *The Moscow Times*, July 20, 1996.

<sup>317</sup> Natalia Dinello, "Financial-Industrial Groups and Russia's Capitalism", March 1997. <http://www.ciaonet.org/conf/sites/iece.html>

<sup>318</sup> Bedirhanoglu, *Predicaments of Transnationalized Passive Revolutions: Transformation of the Russian Nomenclatura in the Neoliberal Era*, p. 210.

<sup>319</sup> *Ibid.*, p. 211.

<sup>320</sup> Sergei Guriev, Andrei Rachinsky, "The Role of Oligarchs in Russian Capitalism," *Journal of Economic Perspectives*, Vol. 19, pp. 131-150, p. 137.

of Russia as men who have amassed phenomenal wealth and power since the collapse of the Soviet Union in 1991.<sup>321</sup>

Weichsel clarifies two main types of oligarch: the *nomenklatura* oligarchs who came from the mid-level to upper ranks of the Communist Party, and business oligarchs who took advantage of the Wild West climate of the *perestroika* and reform. He also argues that, there are four main roots of power for a Russian oligarch: politics, economics, violence management and media. The oligarchs typically gained control through almost all of the categories. The primary reason for all types of root is to gain or protect property rights. Thus, the oligarchs were able to become so powerful in Russia due to lack of property rights in the Russian system.<sup>322</sup>

Vagit Alekperov, the former acting minister of the petroleum industry, who subsequently became the new CEO of Lukoil, and Rem Vyakhirev, the former deputy minister of the gas industry, who became chair of Gazprom were the examples of the *nomenklatura* oligarchs, emerged primarily from the *nomenklatura*. Business oligarchs traded currencies and provided scarce goods and services for extra profits. They also had an advantage over *nomenklatura* in that they knew how to find goods and services in short supply.<sup>323</sup>

In the mid-1990, valuable state property was transferred to so-called private shareholders' associations composed of officials in Moscow. In fact, the transfer of party/state assets to high-level officials took place as early as the failed coup of August 1991. Many officials, such as those in the Central Committee, became recipients of enormous bank credits that could be used for investment and acquisition; others were permitted to purchase hard currency at

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<sup>321</sup> Marshall Goldman, "Putin and the Oligarchs," *Foreign Affairs*, November/December 2004, pp. 10-15, p.10.

<sup>322</sup> Jeffrey Louis Weichsel, "Privately Enforced Capitalism: The Rise (and Fall?) of Russia's Oligarchs", 2004, *Vestnik*, Issue 2, Volume 1, Summer 2005, pp. 33-54, p. 37.

<sup>323</sup> "Russian Privatization Revisited—A Debate Between Goldman and Aslund," *Beyond Transition*, Volume 14/15, Numbers 12&1, December 2003/April 2004, pp. 23-26, p. 24.

reduced prices. This advantages turned many members of the *nomenklatura* into instant millionaires.<sup>324</sup>

Applied Politics Institute of Moscow made a survey of Russia's top 100 businesspeople in 1994. The report of the survey marked that, members of the Soviet era *nomenklatura* accounted for fully 61 percent of Russia's new riches.<sup>325</sup> Ákos Róna-Tas has claimed about the power conversion route into the new economic elite that power accumulated during state socialism was converted into assets of high value in a market economy.<sup>326</sup>

Shares for loan privatization scheme was an important mechanism to the aforementioned power conversion. The scheme consolidated the power of the *semibankirshchina*: the oligarchic “Rule of the Seven Bankers”<sup>327</sup>. The members of the 'Great Seven' were; Boris Berezovsky (Logovaz), Vladimir Potanin (Onexsimbank), Pyotr Aven (Alfa Group), Mikhail Fridman (Alfa Group), Vladimir Gusinsky (Most Group), Mikhail Khodorkovsky (Menatep, Yukos-Rosprom) and Alexander Smolensky (SBS-Agro).

Nellis argues that under the shares for loan privatization scheme, a small number of individuals, (oligarchs) who mostly achieved initial wealth through favourable deals with or outright theft from the government, as in the case of the “authorized banking” issue, ended up controlling most of Russia’s major firms.<sup>328</sup>

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<sup>324</sup> Victoria E. Bonnell, "Winners and Losers in Russia's Economic Transition," In *Identities in Transition: Eastern Europe and Russia After the Collapse of Communism*, edited by University of California Press/University of California International and Area Studies Digital Collection, Edited Volume 93, 1996, pp. 13-28, p. 15.  
<http://repositories.cdlib.org/uciaspubs/research/93/3>

<sup>325</sup> Julie Tolkacheva, “Meet the New Rich, Same as the Old Rich,” *The Moscow Times* September 15, 1994.

<sup>326</sup> Bonnell, *op cit.*, p. 18.

<sup>327</sup> Christopher Cox, *op cit.*, p. 87.

<sup>328</sup> John Nellis, “External Advisors & Privatization in Transition Economies,” *Working Paper of the World Bank’s Operations Evaluation Department*, Working Paper Number 3, February 2002, pp. 1-77, p. 51.

As the oligarchs' power grew, many bought TV stations, newspapers, and other media outlets to promote the Presidential election and blunt public criticism of their activities. They started controlling almost all major Russian newspapers and TV stations.<sup>329</sup>

The 1996 presidential elections was a major event that had influenced the shares for loan privatisation scheme. In the parliamentary election of December 1995, the Communist Party of the Russian Federation, the heir to the Soviet Communist Party, capitalized on economic discontent in order to be the top on polls. The "Our Home Is Russia" movement, led by Prime Minister Chernomyrdin, gained only 10 percent of the popular vote, so Yeltsin's popularity was less than before.

Anatoly Chubais managed the Yeltsin's campaign of the 1996 presidential elections. The Russian mass media was almost completely monopolized by either the state or the oligarchs. The media campaigned on Yeltsin in the 1996 presidential elections. The Independent Television (NTV) that Vladimir Gusinsky had a major stake in and the Russian Public Television (ORT) that Boris Berezovsky, Pyotr Aven, Mikhail Khodorkovsk and Alexander Smolensky jointly acquired over forty percent of the shares in July 1995, were the two largest and most influential television networks in the media campaign.<sup>330</sup>

Paul Klebnikov<sup>331</sup> described the shares for loan privatization process as making Yeltsin re-elected in 1996 by the support of oligarchs. Chubais actually gave the oligarchs Russia's dozen of best exporters firms. Klebnikov also argued that Berezovsky, Chubais and the other oligarchs organized a secret financing of the Yeltsin campaign, collecting at least 300 times the legal limits on campaign contributions from themselves and other businessmen. The official maximum that any candidate could receive in private contributions was

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<sup>329</sup> Black et al, *op cit.*, p. 1747.

<sup>330</sup> Gill and Marwick, *op cit.*, p. 222.

<sup>331</sup> The author of Godfather of the Kremlin: Boris Berezovsky and the Looting of Russia

slightly more than 3 million US dollars.<sup>332</sup> Thus, the government had no incentive to regulate the actions of the oligarchs, because most were close allies to President Yeltsin and funded Yeltsin's re-election campaign in the 1996 presidential elections.

After the 1996 presidential elections, Yeltsin was re-elected. Appointments of Anatoly Chubais as the First Deputy Secretary of the Prime Ministry, Vladimir Potanin as the First Deputy Prime Minister and Boris Berezovsky as the Deputy Secretary of the Russian Federation Security Council followed suit.<sup>333</sup> In this way, the oligarchs confirmed their political power in addition to their economic wealth.

## 5.4 Consequences

### 5.4.1 Quantitative Analysis

Most of the enterprises sold during this period, as mentioned, were high-value energy companies, such as Norilsky Nickel and Sidanco Oil Company. In 1995 alone 12 auctions contributed 5.1 trillion rubles to the federal budget, accounting for 70 percent of that year's budget revenues from privatization. The remaining 2.2 trillion rubbles were received from other cash sales, such as auctions and tenders<sup>334</sup>.

The main aim of the shares for loan privatization scheme was declared as an increase in privatization revenues in order to decrease federal budget deficit. While the federal budget deficit was 5,4 percent of the GDP in 1995, it reached to 7,9 percent of the GDP in 1996.<sup>335</sup>

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<sup>332</sup> An interview with Paul Klebnikov, "Theft of the Century: Privatization and the Looting of Russia," *Multinational Monitor*, Jan./Feb. 2002. pp. 1-7, p. 5.

<sup>333</sup> Gill and Marwick, *op cit.*, p. 196.

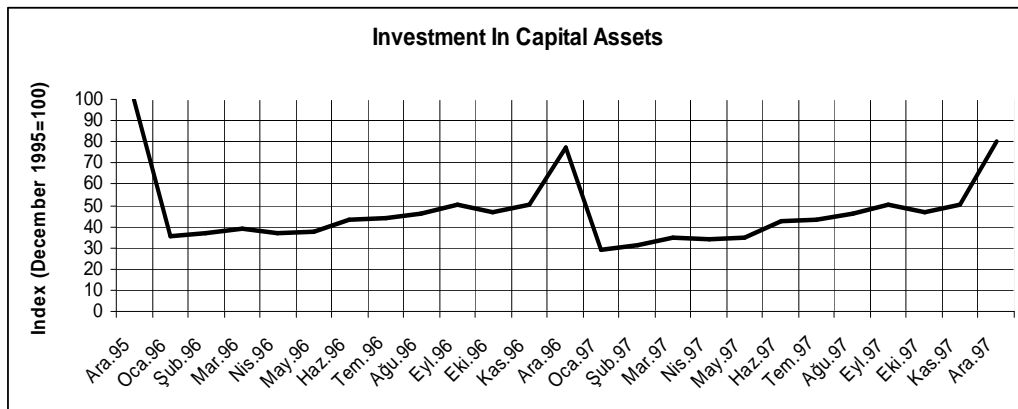
<sup>334</sup> Radygin, "Residual Divestiture Following Mass Privatization: The Case of Russia," p. 17.

<sup>335</sup> Stanley Fischer, "The Russian Economy at the Start of 1998," U.S.-Russian Investment Symposium, at Harvard University, on January 9, 1998.  
<<http://www.imf.org/external/np/speeches/1998/010998.htm>>

Cox argues about the revenue obtained through shares for loan privatization as in the following: “While the corrupt share for loans program passed valuable state assets into the hands of a small circle of well-connected bankers, it provided far too little money to solve the government's cash crisis.”<sup>336</sup>

Mobilization of investments into production was the announced goal of cash privatization program. Monthly investments in capital assets from January, 1995 to December, 1997 are represented by the following graph.

**Figure 5.1 Monthly Investments in Capital Assets from January 1995 to December 1997**



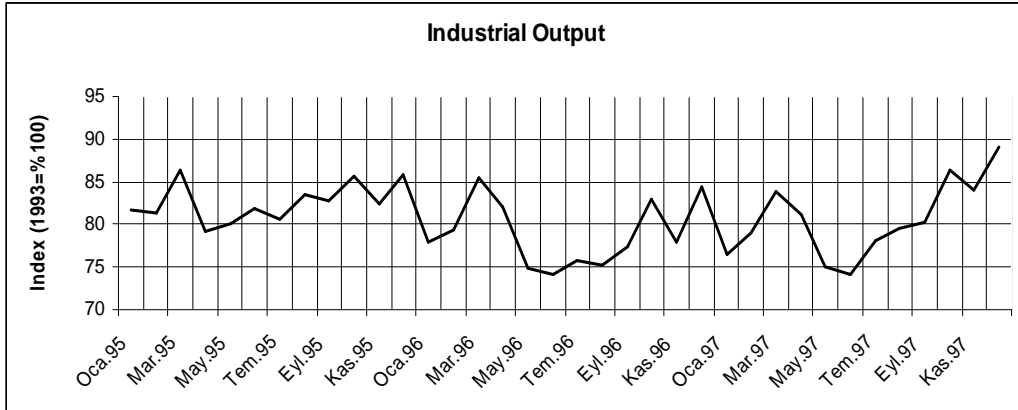
Source: Foreign Investment Promotion Centre <<http://www.fipc.ru/fipc/>>

Excluding some peak points at the last months of the years, investment in capital assets continued to diminish although mobilization of investments into production was aimed in the cash privatization program. Peak points at the last months of the years, show existence of extra investments due to tax consideration.

Monthly industrial output from January 1995 to December 1997 is represented by the following graph.

<sup>336</sup> Christopher Cox, *op cit.*, p. 86.

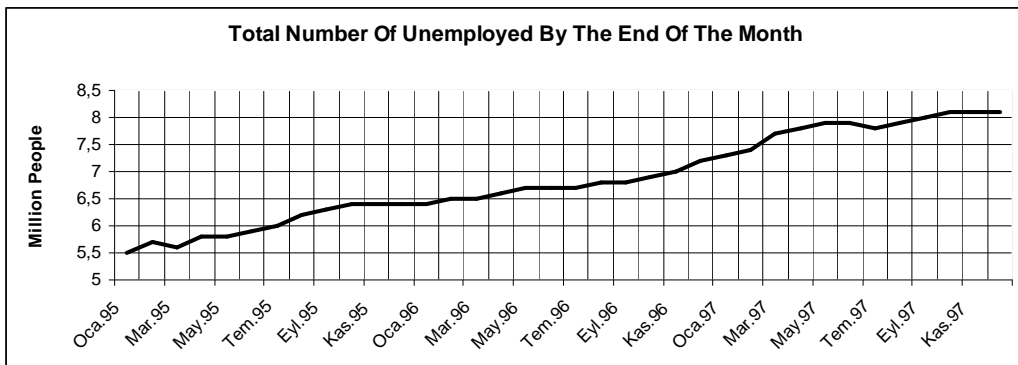
**Figure 5.2 Monthly Industrial Outputs from January 1995 to December 1997**



Source: Foreign Investment Promotion Centre <<http://www.fipc.ru/fipc/>>

As it is clearly seen in the graph above, industrial output did not increase during the cash privatization program. In this period, industrial output remained even below the level of 1993. It is clear that the goal of mobilization of investments into production was not achieved.

**Figure 5.3 Numbers of Unemployed People by the End of the Months from January 1995 to December 1997**



Source: Foreign Investment Promotion Centre <<http://www.fipc.ru/fipc/>>

From another point of view, if the total number of unemployed people at the end of December 1997 is considered, unemployment continued to increase in a steady manner. This situation is represented by the graph above.

In this regard, neither mobilization of investments into production nor the finance of the federal budget deficit could be achieved under the privatization programs.

#### **5.4.2 Qualitative Analysis**

Considerable criticisms accompanied shares for loan privatization scheme. Firstly, the auctions of the blue-chip companies were restricted to the foreign investors. Furthermore, these auctions were not open to the domestic investors apart from the oligarchs. Thus the auctions were uncompetitive. Secondly, there was the issue of conflict of interest, for the organizers of auctions themselves were among the contenders. Thirdly, the starting prices of these auctions were very low as compared with the actual prices of the companies. Moreover, the oligarchs won the auctions with a concealed bid. Fourthly, the organizers of the auctions disqualified rival contenders through miscellaneous pretexts. Thus, in addition to those official and unofficial bans, oligarchs also could exclude any competitors with varied pretexts.

Veniamin Sokolov, the auditor of the Audit Chamber, made a statement about the loans-for-shares auctions by saying that “It must be said with great regret that everything that shouldn’t have been violated in the process was violated.” He also said the auctions were “invalid according to the law” and would be reviewed by the prosecutor general's office.<sup>337</sup>

Therefore, many Russians refer to shares for loan privatization scheme as “grabitization” rather than privatization.

In addition to these arguments, the money that Russian Federation budget provided from shares for loan privatization program was simply

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<sup>337</sup> Peter Serenyi, “Privatization Scheme Illegal, Auditors Say,” *The Moscow Times*, April 5, 1996.



reshuffled from one pocket to another. Cox argues that the funds that were used to purchase shares in the auctions probably included a great deal of the Russian government's own money. Many of the top Russian banks whose owners benefited overwhelmingly from “shares for loan” were successful not as a result of genuine banking activity in the private sector but through their roles as so-called “authorized banks” that handled government funds and made huge profits. Hence, the banks could amass sufficient capital to participate in the “shares for loan” auctions.<sup>338</sup>

Besides, the shares for loan privatization scheme was a method through which Yeltsin could ignore the Russian Parliament. Although the parliament rejected the post-voucher privatization program, it was promulgated by the presidential decree. Thus, major oil and metals companies, described as the “crown jewels of the Soviet industry”<sup>339</sup>, were privatized without approval of the Russian Parliament.

The 1996 presidential elections had a crucial role in the shares for loan privatization scheme. The oligarchs benefited from the shares for loan privatization scheme to fund Yeltsin’s re-election campaign in the 1996 presidential elections.

Consequently the former Soviet *nomenklatura* converted their political capital into private economic wealth via shares for loan privatization scheme and became a dominating capitalist class in the Russian Federation, namely they became “the oligarchs”.

As another phenomenon, the shares for loans privatization scheme was associated with corruption. A major corruption scandal broke out in 1997, when Anatoly Chubais, the then Finance Minister, Alexander Kazakov, first deputy chief of staff, Deputy Prime Minister Maxim Boiko, head of the government's privatization program, and Pyotr Mostovoi, head of the Federal Bankruptcy Agency reportedly received 90,000 US dollars each for contributing to a yet to be published book on Russian privatization. The book

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<sup>338</sup> Christopher Cox, *op cit.*, p. 87.

<sup>339</sup> Bivens and Bernstein, *op cit.*, p. 621.

payments were made by Segodnya Press, a Russian publisher partly owned by an affiliate of Oneximbank.<sup>340</sup> The media group of Logavaz, the rival financial-industrial group of Oneximbank, exposed this corruption. Yeltsin forced the leading private and state companies to pay their tax arrears, thus rival FIGs began to expose their opponents' corruption.<sup>341</sup> Following this scandal Anatoly Chubais was removed as Finance Minister but retained his post as First Deputy Prime Minister.<sup>342</sup> Later in Putin's period Chubais became in Director of United Energy Systems, energy monopoly of the state.

### 5.5 Conclusion

The consequences of the shares for loan privatization scheme were complex. The expected results of the privatization programs, conversion of investments into production and the finance of the federal budget deficit could not be achieved.

Under this privatization scheme, a few firms were sold off to a few individuals. In fact, if we look at the flip side of the coin, we will see that these firms and individuals were the dominant part of the Russian economy and the former Soviet *nomenklatura* respectively. Furthermore, the auctions performed under this scheme were extremely uncompetitive and restricted not only to foreign investors but also to the domestic ones.

In addition, the auctions were held by the so-called "authorized banks". The auction organizers or their affiliates won the auctions. These "selected individuals" were the former Soviet *nomenklatura*.

In this context, the shares for loans privatization scheme was a mechanism that created a new bourgeoisie in Russia. The most rigged privatization scheme Russia had ever faced was a political choice rather than

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<sup>340</sup> CNN World News, November 17, 1997.  
<<http://www.cnn.com/WORLD/9711/17/russia.chubais/>>

<sup>341</sup> Pınar Bedirhanoglu, "Rusya'da Kapitalist Dönüşüm Süreci, Yolsuzluk ve Neoliberalizm," *Toplum ve Bilim*, 92, Bahar 2002, pp. 217-233, p. 229-230.

<sup>342</sup> Gill and Marwick, *op cit.*, p. 197.

economic. Thus, the oligarchs acquired crown jewels of Soviet industry by forming a corrupt capitalist class in the Russian Federation. They also supported Yeltsin with the funds at the 1996 Presidential elections.

So, people who were in the *nomenklatura* positions in the former Soviet Union were able to retain their power and privilege through the post-communist transition by converting their political capital into private economic wealth.

## CHAPTER 6

### CONCLUSION

The main objective of this thesis has been to exhibit the continuity of the dominance of the political power on property relations in the Russian society though a tremendous political change has been experienced in Russia during the transition process from a socialist order to a capitalist one. The *nomenklatura*, who had monopolized the political power in USSR, maintained their control authority over the property relations by their successful interventions in the privatization processes. Thus, the former Soviet *nomenklatura* retained their ruling position in the new capitalist system as the new capitalist class. In order to show the continuity of the *nomenklatura*'s dominant positions over the property relations, their role has been examined in both socialist and capitalist Russia in this thesis.

In order to show the aforementioned continuity, this thesis has focused on the economic reform attempts in the USSR in chapters 2 and 3 and the privatization processes in the Russian Federation in chapters 4 and 5.

It has been shown in the second chapter that, the main features of property relations could not be changed during the reform attempts in the USSR from 1917 to 1985. Persistent attempts to reform the political structure of the USSR through further centralization and/or decentralization in this period generally had started with some reformist legislation, which could never be implemented entirely. The *nomenklatura* was content with its control power over the state assets and opposed any reform attempts which would diminish this authority. Ironically, most of the reform attempts had resulted in the further bureaucratization of the Soviet economic system and increased the *nomanklatura*'s role in the management of it.

In the third chapter, the strong position of the Soviet *nomanklatura* over state assets and their resistance to reform attempts concerning the production relations during the Gorbachev period has been discussed. The conservative

resistance of the Soviet *nomenklatura* against reforms who felt threatened by the reformist wave was experienced again in the Gorbachev era. As the Soviet Union entered to an irreversible road to capitalism in this period, it had a crucial importance in the Soviet history. In this transformation, the Soviet *nomenklatura* struggled hard and in a very corrupt way to maintain their existing control authority over the state assets in the changing socio-economic structure.

The strong position of *nomenklatura* over the property relations in the USSR remained the same in the Russian Federation too due to the ways and methods with which the privatization programs were conducted. The first stage of privatization programs, mass privatizations, was not competitive and open to foreign investors. The enterprise managers had already *de facto* seized many of the rights for ownership of property in the Gorbachev era. Therefore, in the first privatization program, which contained the purchase of mainly small and medium size state enterprises, the managers had ultimately acquired many of the assets. The government had seen voucher privatization program as a means to co-opt managers to its privatization policies by enabling them to get large number of cheap shares. The *de facto* owners of state enterprises became the *de jure* owners. It has been shown in the fourth chapter that, the former Soviet *nomenklatura* played a major role in the transformation of production relations from state control to private ownership and realized this change in the form of maintaining its power on distribution of ownership through several political collaborations. Thus, the party leaders survived in the bureaucracy, and the managers became the owners of the state enterprises which they previously had administered “on behalf of the people” namely, the former Soviet *nomenklatura* transformed itself into a capitalist dominating class in the Russian Federation.

In the fifth chapter, the next stages of privatizations namely cash privatizations and shares for loan privatizations have been examined. The implementation of these schemes was inefficient, corrupt and non-transparent in a number of ways for example; foreigners were barred from participating

and the right to manage the auctions was allocated among the major banks. Besides, the rival bids were excluded through various pretexts.

Although the Russian government launched these privatization programs to find a solution to its budget deficit problem despite the opposition of the Russian Parliament, it found itself more impoverished at the end of these. Because, these corrupt processes of property transfer ended up by transferring the country's most lucrative assets to "oligarchs" in return for making Yeltsin re-elected in the 1996 presidential elections against the powerful communist candidate.

Being the most rigged privatization scheme that Russia had ever faced, the shares for loan privatization scheme was in a way an exchange of state property for political support. Yeltsin was increasingly unpopular and in need of financial and political support from the oligarchs who controlled the country's wealth and media. The privatization scheme created a political pact between the government and the oligarchs. Thus, the oligarchs obtained the crown jewels of Soviet industry, formed a powerful capitalist class in the Russian Federation while campaigning for Yeltsin in the elections.

It has been shown that under this privatization scheme, the former Soviet *nomenklatura* either became whether the new owners of state assets, (which were leading sectors of the Russian economy) or had the authority to determine the new owners through their successful interventions in the privatization processes. In other words, the former Soviet *nomenklatura* was able to retain their power and privilege through the capitalist transformation by converting their political capital into private economic wealth. Thus, the dominance of the political power on property relations during the time of the USSR persisted in Yeltsin's Russia after the collapse of the USSR.

The arguments of this thesis can be re-thought within the context of the recent developments in Russia during the Putin period: most importantly the Yukos/Khodorkovsky case. Putin, while trying to ensure the state's authority over the oligarchs after coming to power, has not refrained from using the state's power of intervention in private property despite huge criticisms of the

West. This was in fact a later stage in the corrupt share for loans scheme as Khodorkovsky acquired this wealth through that process, and Putin was forced to question the legitimacy of this program when Khodorkovsky and Evgeny Shvidler, Chief Executive Officers of Sibneft, rendered an agreement to merge their companies into a giant oil producer with an estimated US dollars 45 billion market value. Yukos&Sibneft would be the biggest companies of the Russian oil companies, producing 30 percent of the Russia's total oil output. Moreover, Khodorkovsky began to negotiate with both ExxonMobil and Chevron-Texaco to sell a blocking 25 percent worth share to the merged company Yukos&Sibneft. Tyumen Oil had formed a partnership with British Petroleum, and several companies, such as ConocoPhillips were secretly engaged in similar negotiations. Then came on October, 25, 2003, Khodorkovsky's arrest and his being charged with tax evasion, fraud, forgery, and embezzlement. Forty percent of Yukos stock was confiscated straightaway in order to prevent the transfer of Yukos' ownership to Western companies. Of course, this case requires a much detailed analysis in a further study, but it can be argued that the Yukos case has been a good example to show that political power still dominates property relations in today's Russia.

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