Chapter Two

Apparatchiki into “Entrepreneurchiki”: The Sources of Russia’s Weak Central State.

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“...the one thing communist states can do is to govern; they do provide effective authority. Their ideology furnishes a basis of legitimacy, and their party organization provides the institutional mechanism for mobilizing support and executing policy.” (Samuel Huntington, 1968,)

As chapter one noted, this book is devoted to explaining the weak political and administrative capacities of Russian central state institutions in the periphery through the first decade of attempted reform following the collapse of the Soviet Union in December 1991.

A thorough analysis of this question, however, requires an examination of the institutional mechanisms by which the Soviet state extended its authority across the periphery. This too begs the question as to whether or not Soviet central institutions were all that successful in
governing disparate territories. For, if the Soviet system was so capable of governing (as Huntington argued in the 1960’s), then how and why did the system collapse? How did the nature of its collapse constrain the reform options for post-Soviet institutional designers? In what ways did these constraints and resulting decisions render Russian central state institutions deficient in penetrating provincial politics? This chapter is organized to respond to these fundamental questions.

One increasingly popular line of argument in the post-Sovietological literature, for example, is to blame Boris Yeltsin, Russia’s first president, and his reform team of “neo-liberal shock therapists” as well as their foreign economic advisors. The general contours of this argument are that first, Yeltsin’s reform team led initially by Yegor Gaidar, named deputy prime minister and minister of finance and the economy in December 1991 (and then acting prime minister in June 1992), urged by their own commitment to “market bolshevism” introduced “shock therapy” to an unwilling and unprepared Russian economy and society. This ill-advised package of reforms included rapid freeing of prices, mass privatization, and the introduction of hard budget constraints on state industry, all of which was mandated by a generally anti-statist ideology.
International financial institutions and the United States provided unwavering support for this program, thus bringing about the criminalization and virtual collapse of the Russian state and, in the words of one commentator, “the worst US foreign policy disaster since the Vietnam war.”³

In sum, this line of argument faults the fundamentally flawed programs of naïve Russian reformers, apparently unaware of the political culture of their own country, who were supported by even more naïve international financial institutions and the United States for the decline of the Russian economy throughout the 1990’s and the weakness of the Russian state more generally. It was these groups that perpetrated the crippled beginnings of the new Russian state and ensured both its incapacities and successive economic crises throughout the 1990’s.⁴

I do not want to defend or attack the internal coherence or advisability of the neo-liberal reform project nor shock therapy. Instead, my goal is to argue that regardless of how ill advised and misdirected they may or may not have been, such programs were never really implemented in Russia following the collapse of the Soviet Union.⁵ Blaming shock therapists for Russia’s weak state and crisis-ridden economy a decade later is undoubtedly looking in the wrong place for a smoking gun. Such arguments also
assume that the reform process started no sooner than
January, 1992 with the freeing of prices under Gaidar and
his associates. This, of course, overlooks the entire
Soviet experience and the possibly that Russia’s current
troubles are rooted more deeply in the past.

In refuting these overly simplified arguments, one
might reasonably ask in exactly what ways the neo-liberal
shock therapy “project” in Russia was successful. Shock
therapy is generally taken to include the rapid
introduction of ten or so economic measures: 1) the
introduction of hard budget constraints on state
enterprises; 2) a tight fiscal and monetary policy; 3) the
introduction of a convertible currency; 4) deregulation of
prices; 5) the destruction of state monopolies; 6) removal
of external and internal trade barriers; 7) a fully
liberated private sector; 8) tax reform; 9) the
introduction of social security and unemployment schemes;
and 10) rapid privatization of state enterprises. All of
this is to be accomplished within a period of three or so
years, if not sooner.

Strictly speaking, however, only a small portion of
this program was ever implemented in Russia (and even then
imperfectly so) in the 1990s. The success of shock therapy
programs really depends on the simultaneous and rapid
implementation of all elements of the plan in an effort to limit the social dislocation associated with the package of reforms. In Russia, though, the attempt to implement this package of reforms was beaten back by firmly entrenched economic forces with strong political clout. Thus, in the face of strong political opposition by June 1992, Gaidar was forced to retreat on his commitment to enforcing hard budget constraints on Russian industry long accustomed to state subsidies as he was forced to issue what became known as “Gaidar credits” through the spring and summer of that year. The desired pursuit of a strict monetary policy also quickly went by the wayside as the Central Bank of Russia by July 1992 headed by the former head of the USSR State Bank, Viktor Gerashchenko, printed money such that inflation became rampant. Far from pursuing an inflationary policy somehow supported by staunch shock therapists, one economist deeply invested in the program infamously deemed Gerashchenko “the worst central banker in history.”

The deregulation of monopolies also clearly did not happen in any significant way in the early years of post-Soviet reform. Indeed, it was only haltingly underway ten years later. Comprehensive and meaningful social security and unemployment insurance programs, ten years later, are also largely still plans on paper. The ruble became
convertible under the rules of the Charter of the International Monetary Fund only gradually (taking about three years to establish). But behind this currency stabilization lay an economy that was largely unmonetized such that taxes were frequently provided “in kind” if at all. It is also difficult to see this as a somehow planned outcome of shock therapy.

Further, comprehensive tax reform was achieved a decade after the initiation of Gaidar’s program under Russia’s second President, Vladimir Putin, although its implementation is still uncertain. Finally, and perhaps most significantly, the privatization program adopted in the second half of 1992 and pursued most forcefully through 1994 left most Russian enterprises in the hands of the insiders who had run them prior to communism’s demise. Privatization, therefore, failed to attain the goals of separating ownership from management and ending soft budget constraints on enterprises. Few firms had gone bankrupt by the close of the decade.

Gaidar himself was replaced as prime minister by Viktor Chernomyrdin in December 1992 and almost all of the initial reform team followed him out of office. Chernomyrdin remained prime minister until 1998 and, as the former Soviet Minister for Gas and Energy, was an
undisputed representative of the old Soviet nomenklatura and industrial lobby. Although he did not roll back everything in Gaidar’s program, he did support Gerashchenko’s inflationary policies for a time as well as reintroducing some price controls.¹³

Moreover, far from supporting the argument that shock therapy alone annihilated the Russian state and led to rampant poverty, unemployment, and inflation, there is more evidence that the Russian attempt at rapid reform was rather quickly overwhelmed. Thus, while the shock therapy paradigm may well have been for Russia ill-advised and generally destructive of state capacities and long term economic recovery, we shall never really know since it went largely unimplemented, and was, perhaps, politically unimplementable given the strength of the forces arrayed against it.

To indict only the small clique of Russian “reformers” surrounding Boris Yeltsin who were in office for only a year or so as well as international financial institutions for what ails Russia, is to really overlook the genesis of Russia’s state building and later state capacity troubles. True, incompletely implemented and hastily conceived macroeconomic reform packages may have contributed to Russia’s longer term economic problems, but this was not the neo-
liberal vision of shock therapy. Indeed, the interesting questions really are why these programs were nipped in the bud, and also what effect their quick defeat tells us about the development of the Russian state’s capacity to lead further economic change in particular.

Rather than blaming only the “market bolsheviks” (Yeltsin, Gaidar and the team of reformers briefly in office in 1992) then for Russia’s economic woes ten years later, I argue instead that the seeds of Russia’s incapacitated state are more firmly rooted in the structure of the late Soviet system and the rapidity and nature of its collapse.

The post-communist state-building project in Russia was subverted by well-entrenched economic elites who had little incentive or interest in building the state’s extractive or regulatory capacities at the expense of their own private extractive opportunities and capabilities. On the contrary, they had every incentive to continue to resist state oversight of their activities and even to actively tear the state down and continue to grab its assets. Thus, the central state’s presence after ten years of reform was only weakly felt in Russia’s sprawling provinces. In this chapter, I make this argument in three stages.
First, I examine the nature of the collapse of the Soviet state and draw a link between that process and the set of economic and political interests that best survived the dissolution of the Soviet Union. Second, I examine how these interests forced compromise and accommodation during the early post-Soviet reform process in Russia such that they were further strengthened. Third, I make the argument that this group formed shifting alliances among themselves and with regional governments to prevent central government penetration of regional politics and economics that might enable better regulation of their activities. This, then, presented the biggest obstacle to further state development and central state capabilities in post-communist Russia.

**The Legacy of Communism and its Collapse:**

The communist state building project was devoted to the development of Soviet Union’s productive capacities. The regime was, of course, aimed toward the future construction of full-blown communism. Toward this aim, the state’s administrative capacities were designed primarily to extract resources to continue enhancing economic growth in both agriculture and industry.

Under Stalin, the Soviet state effectively divested society of virtually all forms of private property and usurped authority over all productive assets. Thus the
early Soviet state extracted resources initially from society (through collectivization of agriculture, for example) in a way that is not entirely inconsistent with the West European experience regarding the development of the state’s administrative capacities for similar ends. The central difference, of course, was that the demands of an overarching ideology of change demanded full divestment of private property in the service of the state. Further, the exigencies of rapid industrialization and modernization in Russia in the early twentieth century more generally required that the state’s extractive and productive capacities be maximized.

Through the effective fusion of the Communist Party of the Soviet Union (CPSU) and the state, and the state and the economy, the Soviet system governed relatively successfully in some important respects, and this is likely why it drew admiration from Samuel Huntington by 1968. It was, after all, remarkably successful in industrializing a largely rural economy in the space of 30 years; adult literacy reached 95 percent by the collapse; it mounted a serious security threat to the United States in its early development and adoption of nuclear weapons technology, to name but a few of its accomplishments. Through campaign mechanisms, it managed to undertake some of the most
ambitious industrial projects the world had yet known – including changing the directions in which rivers flowed, and the construction of massive agricultural and industrial enterprises, all owned by the state, employing hundreds of thousands of workers.\textsuperscript{14} These accomplishments, of course, came at a high social cost – the individual rights and freedoms of the population.

Moreover, Huntington is correct in noting that Soviet rulers did, at least for a time, manage to govern relatively effectively. They accomplished this through the two main institutional bulwarks of the communist state: the Party, and the centrally planned economy, which were from time to time reinforced by a comprehensive security apparatus capable of coercing society by force when required.

The Party and the planned economy provided strong mechanisms of state centralization such that authority clearly spread outward from central party officials and planners in Moscow to their republican and provincial counterparts. As a result, “...in the early years, the institutions that defined socialism produced strong regimes, weak societies and robust economic growth.”\textsuperscript{15} A hallmark feature of the Soviet system was the fusion between the Party and the state and the domination of the
party-state over society. Through this tight association, and the preservation of the state’s monopoly over society and the economy, the system left little room, it would seem, for political and administrative non-compliance to central initiatives. During high Stalinism in particular, the KGB and other instruments of terror as well as the pervasive influence of a powerful ideology helped to preserve the administrative hierarchy.

Given, however, the relatively rapid collapse of this system it is reasonable to question how well the Soviet state actually did govern in practice as it matured. That is, the Soviet state may have been strong despotically (as Mann would describe it), but in the longer term it proved itself to be administratively weak and lost the ability to govern effectively. Thus, the Soviet state, by 1985 and Mikhail S. Gorbachev’s ascension to power, was arguably a “hard” state in that it still possessed considerable despotic power relative to society (although this too was on the wane), but its administrative capabilities and status as a “strong” state were thrown into serious doubt.¹⁶

The causes of the collapse of the Soviet Union have been the subject of several excellent analyses, some of which I draw on in what follows.¹⁷ It is not my purpose to provide a new explanation of the system’s demise as much as it is to
show how and why the way in which the system collapsed gave rise to the set of political and economic interests that so negatively affected the governing capacities of the post-Soviet Russian state through the 1990’s.

As Valerie Bunce has deftly shown, “the sudden collapse of socialism was long in the making.” The seeds of destruction of the Soviet party-state were arguably embedded in some of the very institutions that Huntington identified as being the source of the Soviet state’s seemingly awesome governing capacities. As the system matured and the economy grew more complex, it became increasingly difficult for the party to mobilize unwavering support for its policies. Further, the economy, in a sense, became a victim of its earlier successes. As it grew and became more diversified, the planning mechanisms that had worked so well in ensuring rapid industrialization decades earlier, proved incapable of efficiently managing a much larger and more complicated system.

Economic growth had also slowed considerably with the end of the large industrialization projects of the 1950’s and 1960’s. Given that socialist systems depended heavily on the growth imperative for their survival and the strict control over the economy and politics through the party, “if the economy faltered, especially over an extended
period of time, then the regime would necessarily weaken in the face of deregulatory pressures.”\textsuperscript{19} Indeed, the economy did begin to falter under Leonid Brezhnev’s long tenure as General Secretary of the CPSU. Through the 1970’s the system stagnated politically, socially and economically. Elite interests in the center and periphery grew increasingly differentiated. Donna Bahry found that provincial elites had grown highly resentful of a lack of career opportunities in Moscow.\textsuperscript{20} This was highly problematic for a system so dependent on elite cohesion and cooperation. It was in response to these systemic deficiencies that Gorbachev initiated perestroika upon his ascension to power in 1985.

Still, despite these problems, the collapse of the Soviet system was not inevitable. Indeed, highly respected analysts were able to write as late as 1986, barely a year after Gorbachev had come into office as the last General Secretary of the Communist Party of the Soviet Union (CPSU) that “As the post-Brezhnev era takes shape, the survival of the Soviet system is not in question, but the utility of its policies is.”\textsuperscript{21} Why then, did the Soviet state and its complex network of administrative institutions collapse so quickly following the reforms initiated by Gorbachev in the late 1980’s?
The most compelling set of explanations focuses on the internal dynamics of the Soviet system as Gorbachev initiated his reforms of the two main structural bulwarks of the entire system: the planned economy and the party. Unwittingly (and therefore unpredictably not only for Soviet watchers), as he tried to save the system, Gorbachev struck at the institutional cores of the entire governing apparatus of state socialism. As Bunce, and others have noted, the institutional framework of communism made it extremely elite sensitive and highly dependent on complex hierarchies of authority. Gorbachev’s reforms between 1985 and 1990 effectively deregulated these hierarchies and helped to bring about the collapse of the Soviet state from “within” rather than from above (by a failed attempted coup of elites opposed to Gorbachev in August 1991) or below (from societal mobilization of which there was surprisingly little in the fading years of the Soviet Union) as contending theories of state collapse would posit.

More specifically, by loosening the Party’s monopoly on power through the introduction of (limited) political competition at the same time that the economy was deregulated through tentative market reforms in the late 1980’s, Gorbachev undermined longstanding hierarchies of authority linking bureaucrats and party officials in the
center and the periphery. Of particular relevance to the
argument advanced in this study, Gorbachev’s reforms
coupled with the institutionalized deficiencies of the
planning mechanism, effectively caused the rise of
directors of large, formerly state owned enterprises, as
powerful, autonomous political forces intent on resisting
further state development and regulation in the post-
communist era.

Moreover, “Gorbachev’s economic reforms worsened the
dysfunctions of central planning just as his political
reforms were eliminating the Party as the key agent
responsible for dealing with these dysfunctions.”23 These
dysfunctions included the inabilities of central planners
in the State Planning Agency as well as various ministries
under whom factories were subordinated to perfectly
anticipate the inputs required by enterprises throughout
the Soviet Union given the difficulty of accurately
measuring outputs.24 Part of this difficulty was also due to
the propensity of factory managers to systematically under-
report outputs so as to prevent the “ratchet” effect of
future plans such that they would require greater levels of
output. (Under-reporting output also enabled managers to
sell excess output on the black market.) As a result, party
first secretaries at the provincial level frequently
stepped in to grease the wheels of supply (and demand) for enterprises located within their regions.

Jerry Hough first documented this well-known phenomenon in 1969, when he likened the activities of Soviet first party secretaries to that of French provincial prefects.25 The practice of assisting in provincial supply and production networks clearly extended through the late Soviet era as well. Indeed, in his first set of memoirs, Yeltsin himself reported that he initially met Gorbachev when the former was the first party secretary of Sverdlovsk oblast and the latter held the same position in Stavrapol in the 1970’s. The two exchanged Sverdlovsk’s industrial products for Stavrapol’s foodstuffs.26

Gorbachev’s set of economic reforms hit at both the vertical line of authority stemming from economic ministries through to the enterprise level and the less formal horizontal line of authority that had long been the practice among party functionaries in the provinces. Regarding the mechanisms of vertical control, Gorbachev’s deregulation of planning mechanisms through his 1987 Law on State Enterprises and the Law on Cooperatives of 1988 presented enterprises with new opportunities to direct resources out of the control of central planning agencies. State enterprises were now allowed access to new domestic
and foreign markets. They were also permitted to form daughter companies (or cooperatives) through which they could spin off profits from the sale of excess productive output or new production. These reforms, therefore, exacerbated the previously existing principal-agent problem embedded within the system of central planning and made worse by the increased complexity of the Soviet economy over time. That is, principals within central planning agencies gradually lost control of their agents (enterprise directors) who had greater knowledge of the actual operations of their enterprises.

In one of the most detailed and thoughtful studies of the systemic effect of reforms in this period, David Woodruff argues that,

...by 1990, enterprises were experiencing the relationship with their superior organizations as increasingly extortionate. The supplies and assistance that had previously accompanied higher-ups’ demands to meet plan targets were gone, but output was demanded anyway. In response, to the extent that they were able, enterprises exited these relations to use those of the horizontal economy. And this weakened the vertical economy still further.27

As a result, non-compliance to the plan gradually increased as party secretaries became even more involved in barter for their provincial enterprises and to provide for
local consumer needs that were no longer being satisfied as a result of the disintegration of planning mechanisms.\textsuperscript{28}

Not only did they become adept at the practice of hiding revenues from central planners or reselling excess enterprise production for a personal profit, but under Gorbachev’s reforms (particularly the allowance for the establishment of cooperatives), opportunities for enterprise directors to derive more personal wealth from state property were greatly increased.\textsuperscript{29} The Law on Cooperatives in particular allowed wily enterprise directors to set up cooperatives that were sometimes joint ventures or lease agreements that generated private profits from state owned assets.

At the same time, enterprise directors clearly had doubts about the center’s ability to punish their activities beyond the plan. This, in turn, provided further motivation to collude with regional authorities through horizontal networks to extract inputs and dispose of outputs beyond the plan rather than working through the traditional vertical hierarchies of central planning agencies. This initiated the wave of “spontaneous” privatizations of the late 1980’s whereby enterprise management took de facto control of their factories.
In sum, enterprise directors, by 1991 and the ultimate collapse of the Soviet Union, had often become the undisputed rulers and sometimes de facto owners of their enterprises. The deficiencies of the Soviet planning mechanism in a complex economy, combined with presumably unanticipated opportunities wrought by Gorbachev’s ill-conceived set of reforms, turned Soviet apparatchiki into entrepreneurchiki.

Finally, Gorbachev’s relinquishment of the party’s monopoly on political power in February 1990, and his introduction of limited, but competitive, elections throughout the Soviet Union later that year, however, weakened the party’s monopoly on the polity as well as the economy. Party secretaries could no longer count on being in control of regional legislative bodies of power. Indeed, many lost their positions in the elections and their unwavering control of provincial politics as a result. Most importantly, the seat of political power in the provinces began to move from the party first secretary to elected regional governments at the same time as vertical lines of authority within the party itself weakened. The political point of reference for newly elected provincial officials was in their localities more than in Moscow.
At the same time, by 1990 and the summer of 1991, Gorbachev was locked in an intense political battle with Boris Yeltsin (elected president of Russia in June 1991) over central authority in the Russian republic itself. Yeltsin adeptly manipulated the concerns of Russian provincial leaders to turn them to his side in the struggle with Gorbachev and the Soviet state, infamously exhorting them in 1990 to “take as much power as you can swallow.” Prior to the attempted coup against Gorbachev by members of his own Politburo in August of 1991, Yeltsin took the unprecedented measure of banning the CPSU on Russian soil, putting yet another nail in the coffin of the Soviet state.

Moreover, the set of political and economic reforms under Gorbachev, then, triggered the rapid disintegration of the main institutional bulwarks that had sustained the Soviet Union as a highly centralized, coherent political and economic system and ultimately as a nation-state. By the fall of 1991, little then was left of the governing system of the Soviet state. The economy was in a shambles (with a budget deficit of 20 percent of GDP, rising inflation, acute shortages of goods such that there was a realistic fear of famine), the party was destroyed, and the formerly all-powerful ministries of the USSR quickly came under
Russian control. This was the legacy left to Russian reformers in the winter of 1991-1992.

The Russian Inheritance: Apparatchiki into Entrepreneurchiki

Frequently, analysts describe Russian civil society as “stunted” or “flattened” in the wake of communism’s demise. But it is important to note that this characterization stems from a blurring of the lines between civil society and the state within the communist system itself (that is, where did the state end and society begin?). For civil society in the sense of well-formed interest groups autonomous from the state may have been emerging (indeed, proliferating) by 1991 only to evaporate a year later. Nonetheless, well formed political and economic interests that emerged out of the ruins of the Soviet state itself already constituted a robust and active interest group that endured throughout the 1990’s.

Their preeminence evolved at least partly from the way in which the Soviet economy had developed such that it was dominated by relatively few, large enterprises to more easily facilitate centralized planning of productive inputs and outputs. As a result, by the end of 1988 in Russia, the 23,766 existing large and medium sized enterprises (those
with over 200 workers) employed 95 percent of the workforce and produced 95 percent of economic output. Even more indicative of the degree to which productive capacity was highly concentrated, 75 percent of employees and production were in enterprises with over 1000 workers.\textsuperscript{31}

Through the decade after the collapse of the Soviet Union, it was still this group of “entrepreneurchiki” (Soviet apparatchiks turned post-Soviet entrepreneurs) that had such a dramatic and far reaching effect on the development and governing capacity of the post-Soviet Russian state -- capacities that had clearly declined relative to even the late Soviet state.\textsuperscript{32} Unlike the dominant accounts of West European state building where administrative capacity was built out of the ruling elites’ desire for resources to make territorial conquests, in post-communist Russia during and immediately following the collapse of the Soviet Union, state administrative capacity was rapidly torn down to grab assets that did not reside within society, but within the state. Thus, it became perfectly rational for Soviet bureaucrats, like enterprise directors, to “steal the state” itself.\textsuperscript{33} The main inheritance then, of post-Soviet rulers was a rapidly disappearing and severely debilitated state that became even more so. Moreover, one can also argue that the dynamic
of post-Soviet Russian state building was reversed from the dominant West-European model outlined in chapter one. The very fact that assets were vested within the Soviet state itself rather than within society meant that as the system began to unravel, apparatchiks — as de facto owners of state assets -- had a clear incentive to grab as much as they could.

Even immediately following the collapse of the Soviet system, former apparatchiki as de facto owners continued to tear the state down by extracting its assets rather than building it up through extraction from an impoverished society.

Further, contrary to the analyses of those who would blame Boris Yeltsin and his successive teams of reformers for the sorry condition of the Russian state a decade after the collapse of the Soviet Union, it was the apparatchiki turned entrepreneurchiki (themselves products of the dysfunctions of the Soviet system and Gorbachev’s haphazard reforms) who should be looked at far more closely as the perpetrators and sustainers of Russia’s incapacitated state. These powerful interests clearly inserted themselves into the reform process by mid-1992 effectively ending the attempt at shock therapy after only six months and ensuring further that the first wave of privatization presented no
challenge to their newly found gains. In his memoirs, Gaidar would later say of this group: “It went for the scent of property, as a predator goes for his victim...Nobody fired any managers of state companies or ministerial bureaucrats, nobody seized their bank accounts...and they were allowed to keep their status, wealth and connections.” Indeed, they managed to extract enough compromises from Yeltsin’s team that privatization of large enterprises established enterprise directors as de jure, not just de facto, owners of their factories.

The interdependence and collusion between regional enterprises and governments stems back, as I have argued already, into the Soviet era, but the 1992 privatization program institutionalized the de facto ownership that many managers had established over their factories and thus further cemented enterprise-government dependencies. Initially, Anatolii Chubais and his team at the newly created State Committee for the Management of State Property (Goskomimushchestvo or GKI) argued against a privatization program that would grant special privileges to employees and enterprise directors. But given the opposition that was mounting against privatization through 1991 and 1992, combined with the degree to which the economy had already collapsed and the extent to which
spontaneous or insider privatization had already taken place through the late Soviet era, Chubais was forced to make a serious compromise on insider privilege.\textsuperscript{36}

All three variants of the 1992 mass privatization program under Yeltsin (and under which 15,000 firms were privatized) enabled insiders – both managers and workers – to purchase between 40 to 51 percent of shares outright. Of the three options under which enterprise employees and directors could choose to privatize their enterprise, the most popular (chosen by 73 percent of enterprises) was “option 2” which allowed for majority (51 percent) employee ownership. It is important to note that workers and managers of enterprises did not have to compete with outsiders for this initial block of shares. This went some distance in assuaging their earlier fears that they would lose control of their respective enterprises (and job security as a result) to outsiders. Employees and managers could also purchase additional shares through vouchers and also through the employee pension plan.\textsuperscript{37} Although Chubais clearly opposed this degree of insider ownership, he was largely forced to concede this option to get the program passed in the Supreme Soviet (as the Russian parliament at the time was known) and implemented by regional officials and enterprise managers.\textsuperscript{38}
Indeed, the fact that the privatization vouchers issued to every man, woman and child in Russia were also tradable under the program allowed insiders to buy additional vouchers, and thus additional shares in their enterprises. In a survey of general directors of enterprises conducted throughout Russia in 1994 and 1995, respondents reported that on average, “they paid forty times less than the enterprise was worth.” Thus, compromises built into the privatization program, despite the clear misgivings of its “market Bolshevik” designers, enabled insiders to maintain and even more firmly establish their effective control over their enterprises. This, in turn, consolidated a property rights regime that has proven difficult to change and that was not only a drag on investment and productivity, but also provided a political base for powerful elites to resist central state interference in regional economies and politics.

The designers of the privatization program justified these huge concessions to managers hoping that they would effectively buy and ensure their participation. The high degree of insider privatization that was condoned by the program was also a way to provide some assurance to newly elected regional governments that regional outsiders would not immediately be empowered to substantially interfere
with the regional economy for which they were now accountable through elections. In addition, the program gave an incentive to regional governments to participate in the privatization process by granting them blocks of shares of between 15-20 percent in certain enterprises (to either be held or sold later) as well as enabling them to get a percentage of funds from the auctions that were held for the remaining shares. (Later, some enterprise managers would openly report that local privatization officials had assisted them in effectively blocking the participation of outsiders in provincial auctions of enterprise shares.)

Despite the concessions made to the major stakeholders (enterprise directors, workers and regional and local governments), the hope was that gradually, outsiders would invest in these firms and that ownership and management would become separated. By the end of this phase of the program, employees owned a majority of stock (51 percent or greater) in about 65 percent of the 15,000 large and mid-sized enterprises privatized between 1992 and 1994. More than five years later, however, there is general agreement that managers and employees continued to hold 50 to 60 percent of shares in privatized enterprises. Some analysts have claimed, therefore that “such a
concentration of employee ownership of the core of an economy is unprecedented in world economic history."^42

To add further perspective to this claim and these numbers, it is important to note that managers’ de facto control of their enterprises often exceeded their actual direct ownership of shares of their companies since many employee shares did not come with voting rights. Managers also routinely employed tactics (like threatening layoffs or firings, withholding wages, etc.) to prevent employees from selling their shares to outsiders. Finally, most corporate boards of privatized companies had a majority of insider membership, most enterprise directors reportedly opposed the disclosure of ownership and financial information and most had conducted little restructuring by 1996.^43

Moreover, by 1999 “despite other positive signs in the Russian economy, the enterprise sector remained in a low investment, low productivity trap.”^44 Wage, supply and tax arrears persisted and inter-enterprise barter payments reached half of all industrial sales by mid-1999. ^45 Insiders received particularized benefits while the general state of productivity and investment declined. Although the original argument for rapid privatization was to prevent asset stripping by industrial managers in state owned
enterprises (and also to forestall any further “spontaneous privatization” of enterprises by management), in fact they persistently grabbed and resold assets from their newly privatized firms. World Bank analysis indicates that, instead of increasing a firm’s value through reinvestment, enterprise manager-owners have typically extracted income streams from these firms at the expense of minority shareholders. The managers have diverted cash flows to offshore accounts and shell corporations, concentrated losses among subsidiaries held by outsiders... and delay[ed] payments of dividends.\textsuperscript{46}

Other studies by the World Bank characterize the dynamic between enterprises and the state in some post-communist countries – including Russia – as indicative of a form of state capture.\textsuperscript{47} State capture is understood to denote both the influence a firm may have on the formation of laws as well as administrative corruption which may entail not only conflict of interest of government officials, but also private payments by firms to public officials to “distort the prescribed implementation of official rules and policies.”\textsuperscript{48}

Analyses employing the 1999 Business Environment and Enterprise Performance Survey (or BEEPS) of over 3000 firms in 20 countries in Eastern Europe and the former Soviet Union, indicate that both older and newer firms engaged in attempts to influence and often capture the state. This
behavior on the part of firms was to ensure the perpetuation of the property regime described above that favors them (by limiting competition and entry into their markets, preserving their rent seeking opportunities and also protecting them from central state regulation and taxation). More specifically, these firms (especially those privatized firms as opposed to those born private, but to some degree the latter as well) in particular want: continued state subsidies (that is a continuation of soft budget constraints as well as subsidized energy supplies); relief from paying taxes; and protection from outside competition.49

It would be a mistake, however, to assume that regional governments in Russia were merely victims of this kind of behavior on the part of emerging “entrepreneurchiki” rather than frequently willing participants in an interdependent or more collusive relationship. It is not clear, therefore, that regional governments were “captured” per se. Indeed, regional governments often sought to maintain involvement in and sometimes control over the operations of regional enterprises particularly important to the regional economy - even if the latter were formally privatized. This was often to prevent large-scale changes within enterprises.
that might threaten the local workforce with unemployment and “to preserve the rent-seeking opportunities for vested interests.” Moreover, far from strictly a system of state capture, a regime of interdependence grew up between regional business and government that favored the economic status quo:

In certain regions ... the nexus of interdependence between government officials and enterprise management typically granted management quasi-governmental powers, including influence over executing and law-enforcing apparatus in a given locality, ...  

The stakes of the relationship were high for local governments not wanting large factories within their regions to go bankrupt since this would mean widespread unemployment. Since the workforce of the enterprises also constituted the voting public, the futures of regional politicians were quite tightly bound up with the success and failures of enterprises.  

In addition, another holdover from the Soviet era further bound regional politicians in the post-Soviet era to the success of regional enterprises. Many important social services (kindergartens, housing, vacation properties) were still provided through large formerly state enterprises. Should, therefore, the ownership of the enterprise have attempted to seriously change the status
quo in this regard and divest the enterprise of these social service burdens, impoverished regional governments would be left to assume responsibility for their provision. As a result, collusion between business and government at the regional level in Russia persisted – to the detriment of the central state’s ability to create a single political and economic expanse and govern it effectively.

Examples are abundant of provincial politicians becoming deeply involved in the financial transactions of “privatized” enterprises located within their provinces. Woodruff, for example, finds that regional governors in particular were integral figures in facilitating and even promoting barter transactions between enterprises in their regions and enterprises elsewhere. He claims, therefore, that this made them “facilitators” of the defense of the organization of production at the regional level. In many regions, oblast governors assumed the former role of “party secretary” or “prefect” in stepping in to assure back payment of wages for employees of privatized companies, or even in attempting to remove directors of failing privatized enterprises.

Regional governments also became involved in protecting local industry from the formal effects of national price control policy for example in the provision
of electricity. In two of the three provinces Woodruff examined, regional governors did this successfully, in the third, when he tried to force enterprises to pay their electricity debts to the federal utility, their directors engineered the dismissal of the governor.\textsuperscript{55} Finally, local governments even aided, says Woodruff, enterprise exits from the monetary economy through their acceptance of enterprise tax payment in kind and other surrogate monies (wechsels).\textsuperscript{56} This effectively maintained a soft budget constraint for many enterprises.

Another notorious example of this kind of political protection of local "private" enterprise concerns the attempt in 1996 to force the largest tax debtors to pay into the federal treasury. The Chernomyrdin government created a "Temporary Extraordinary Commission" (or VChK) possessing considerable authority to collect back taxes through a schedule acceptable to the federal government. If the enterprise did not follow the schedule or could not pay at all, the VChK was empowered to initiate bankruptcy procedures. This federal effort to collect from delinquent enterprises, however, was soon stymied by regional governments aiming to protect local industry. Courts for the most part failed to act when bankruptcy proceedings were brought against big debtors. As it turned out, after
its first several months in operation, the tax arrears of VChK targeted enterprises had frequently increased and few bankruptcy decisions were actually implemented.\(^{57}\)

Adding further balance to the picture of regional governments as potentially “captured” by regional entrepreneurs are examples from a host of regions that demonstrate the extent to which regional governments themselves became active participants in the regional economy or even attempted to subordinate enterprises to their wills. For example, in Pskov oblast, the regional government created regional government enterprises. In 1997, the regional government established a new enterprise “Pskovkhleb” – a bread company – under the directorship of the deputy governor for agriculture and food processing. He pressured a private flour mill to supply flour at below market prices so that Pskovkhleb could sell bread at a price approximately 30 percent lower than private bakeries. While on the one hand, this may have enabled the oblast government to provide bread to the population more cheaply, on the other hand, it violated a host of Russian laws, including the federal law on competition.\(^{58}\)

Still other provinces not only banned imports into the province to protect local products, but also became producers themselves by purchasing controlling shares in
regional enterprises, effectively de-privatizing these companies. Some regional governments maintained their original shares in enterprises, establishing these regional governments as co-owners.

Other scholars have characterized the relationships that emerged (or persisted) between regional business and enterprises as “feudalistic” in that they were characterized by: a traditional legitimacy over an inherited realm of personal control; highly personalistic authority and discretion over decision making as opposed to reliance on law; and more generally, a pattern of economic activity based on personal networks and mutual obligation rather than enforceable contracts and inviolable property rights. Many of these behaviors are reminiscent not only of feudalism perhaps, but more properly, of the late Soviet political economy described earlier in this chapter.

While it is important to note the obvious negative economic effects of the interdependent relationships between business and government at the regional level in Russia, this study directs attention to the often overlooked negative political effect that the collusive interdependence of regional governments and business had on what the central state could actually accomplish at the regional level. I argue that the regional governments and
enterprise directors, who in many ways benefited, but also suffered from the transition had little interest in promoting central state regulation of their activities. In order to protect their early financial and property gains, and maintain the fragile economic status quo within their regions, they effectively carved up the political authority of regional governments, largely, although not exclusively, for personal financial advantage.

The theory and evidence here provide a deeper understanding of why it was that the federal tax police, for example, by the admission of the director of the federal Tax Inspectorate, required the good will of the regional governor to collect taxes due to the federal budget\(^6^2\); why federal pension authorities required the cooperation of regional governments to extract pension payments from regional enterprises; and why federal organs as reputedly powerful as the Ministry of Internal Affairs (successor to the KGB) could be resisted and stopped by regional economic interests in cahoots with regional political authorities.\(^6^3\) In short, the Russian central state only weakly penetrated regional politics and faced strong resistance to many of its policies in the heartland.

Moreover, the Russian state building project became stalled and the state’s governing capacities were limited
since the goal of firmly entrenched elites at the regional level was to keep the central state from regulating or otherwise interfering with their activities. Rather than building the state by extracting resources from society, these interests subverted central state reconstruction and undermined central state governing capacities to preserve what they extracted, and continue to extract, from the state itself. The empirical materials in chapters 3 and 4 demonstrate the degree to which central state penetration of politics in the periphery was actively resisted at the local level. Chapter 5 then details empirically how the collusive relationship described above brought about this situation. It is to these tasks that I now turn.

2 Reddaway and Glinsky, p. 233-34.
3 Cohen, p. 9.
4 Reddaway and Glinsky even appear to fault neo-liberals in Yeltsin’s government for the breakup of the Soviet Union in December 1991, although the “shock therapy” program did not begin until January 1992.
6 This is somewhat ironic since Cohen for example, faults American academia for overlooking Soviet history in its supposedly flawed analyses of Russian politics in the 1990’s.
8 Aslund, p. 97.
9 The quote is from Jeffrey Sachs. See Aslund, p. 94.
12 Rutland, p. 15.
13 Aslund, p. 92.
14 See for example, Steven Kotkin, Magnetic Mountain: Stalinism as a Civilization, (Berkeley: University of California Press, 1997)
16 The distinction between a hard state and a strong state comes from Myrdal, 1971 cited in William Zertman, ed., Collapsed States: The Disintegration and Restoration of Legitimate Order, (Boulder: Lynn Rienner, SAIS African Studies Library, 1995), p. 7. Note though, that the late Soviet state was apparently still more capable of providing basic public services than was the post-collapse Russian state cf. chapter one, page 3 regarding comparative death and infant mortality rates.
18 Bunce, 1999, p. 38.
19 Bunce, p. 56.
24 These were noted initially in Joseph Berliner, Factory and Manager in the Soviet Union (Cambridge: Harvard University Press, 1957).
26 Boris Yeltsin, Against the Grain, (New York: Summit Books), p. 71
27 Woodruff, p. 67.
28 Woodruff at p. 70 cites the example of an altercation in 1990 between Krasnoiarsk and Omsk Provinces over delinquent deliveries of planned shipments.
30 Aslund, p. 52.
32 It is worth distinguishing between those enterprises that were “privatized” in the first wave of privatization in particular and those that were “born private” or that never existed previously as state enterprises. In this book, I am focusing more on the former and not the latter. See Thane Gustafson, Capitalism Russian Style (New York: Cambridge University Press, 1999), pp. 36 and 37.
33 Solnick.
35 Yegor Gaidar, Gosudarstvo i evolyutsia (The State and Evolution), p. 155.
37 Blasi, Kroumova and Kruse, p. 41.
38 Aslund, p. 234.
40 Blasi, Kroumova and Kruse, p. 52.
41 Desai and Goldberg, p. 5.
42 Blasi, Kroumova and Kruse, p. 58.
These details can be found in table 9 of Blasi, Kroumova and Kruse, pp. 200-201 and are based on responses to surveys conducted of enterprise managers between 1994 and 1996. Note also that there are, of course, exceptions to these trends. Kathryn Hendley, for example, writes convincingly of the situation at the Saratov Aviation Factory (SAZ) where clearly attempts at restructuring had taken place, but the obstacles to actually bringing about meaningful restructuring within the context of declining orders and poor state support were considerable.

Desai and Goldberg, p. 7


Hellman, Jones and Kaufmann, p. 2.

This is not an exhaustive list, but it covers the main concerns of most enterprises engaged in collusive activity with regional governments. Peter Rutland provides a slightly different wish list for enterprises in “Business Lobbies in Contemporary Russia,” International Spectator, vol. 32, no. 1, January-March 1997.

Desai and Goldberg, p. 10.

Desai and Goldberg, p. 10

I have made this point previously in Local Heroes: The Political Economy of Russian Regional Governance, (Princeton: Princeton University Press, 1997).

Woodruff, p. 137.

For example, see Kathryn Hendley, “Struggling to Survive: A Case Study of Adjustment at a Russian Enterprise, Europe-Asia Studies, vol. 50, no. 1, 1998. Hendley recounts the story of the governor of Saratov province in 1996 dismissing the general director of Saratov Aviation Factory, a privatized firm. Although the dismissal was apparently welcomed by at contingent of workers, since the governor had overstepped his legal authority, the director of the factory ignored the order.

Woodruff, p. 145.

Woodruff, p. 146-158.


This example is drawn from Darrell Slider, “Pskov Under the LDPR: Elections and Dysfunctional Federalism in One Region,” Europe-Asia Studies, vol. 51, no. 5, July, 1999, p. 762.

Slider, 1999 and Saratov in 1997 of 1998 see database on this.


Note that Ken Jowitt in New World Disorder: The Leninist Extinction (Berkeley: University of California Press, 1992) at p. 226 argues that personalistic rule is clearly a part of the Soviet legacy thereby further refuting those who would blame this aspect of post-Soviet political economy on shock therapy alone.

An interview with Sergei Amazov, director of the federal Tax Inspectorate (or Tax Police), February 1999 as cited in Gustafson, p. 201, fn. 34.

This last example is drawn from Slider on Pskov.