

February 6, 1992

## THE CREEPING COUNTERREVOLUTION IN RUSSIA: LOCAL RESISTANCE TO PRIVATIZATION

By **Alexandr Urmanov, Ph.D.**  
E.L. Wiegand Fellow

### INTRODUCTION

After Boris Yeltsin won the presidential elections in Russia last June 13, the reformers faced two main tasks in dismantling the communist system. The first objective was to eliminate the political and ideological dominance of the Communist Party. The second goal was to replace the inefficient state-owned economic system with one based on private property.

The first task was completed by the defeat of the hardline Communist coup on August 19 to August 22. All the Communist Party structures were completely destroyed in the wake of the coup. Yeltsin prohibited the activity of the Communist Party in Russia on August 23, and the local authorities took over its property. The subsequent evaporation of the Soviet Union and the creation of the Commonwealth of Independent States in Alma-Ata on December 11 have made the demise of the Communist Party's rule irreversible.

**Steps Toward Free Markets.** Accomplishing the second task of privatizing the economy has been slower. The reason is not a lack of interest on the part of Yeltsin's government. Following Yeltsin's October 28 speech to the Russian parliament, in which he unveiled his program of radical economic reform, the Russian government introduced and the Russian parliament passed a number of laws

---

After completing his term as The Heritage Foundation's E.L. Wiegand Fellow, Alexandr Urmanov has returned to the *Sodruzhestvo* (Cooperation) Foundation, where he is Chairman of the Urals Division. The Foundation is located at Lenin Ave. 24-450, Ekaterinburg, 620038, Russia. Telephone (3432) 589-731.

Urmanov is a top political advisor to Boris Yeltsin and one of the few professional political campaign managers in Russia.

to further reform. Examples: the Yeltsin November 17, 1991, decree freeing foreign trade from centralized state control; the December 28 Land Privatization decree, which calls for the transfer of much of the collective farms' land to private farmers; and the December 29 Enterprise Privatization decree, which calls for "accelerated privatization of state and municipal enterprises." Finally, on January 2, 1992, the Yeltsin government took a decisive step toward a market economy by freeing prices, which from that time on were supposed to be dictated by the market forces of supply and demand, rather than set by the government bureaucracy.

The Yeltsin government also took administrative steps to assure that privatization occurred at the local level of government. A special Russian government agency, called the Committee for the Management of State Property, was created by the central government to oversee the privatization of state-owned properties by the municipal and regional governments. This Committee has branches in all regions of Russia. Furthermore, Yeltsin has appointed governors and presidential representatives for the regions to ensure that his economic reform policies are followed by local officials.<sup>1</sup> The presidential representatives have the authority to make recommendations to Yeltsin about which steps should be taken to expedite free market reforms in their provinces. They may even recommend removal of local officials who sabotage the reform.

**Serious Problems.** Yet, despite all these measures, it is becoming increasingly clear that Yeltsin's free market reform has run into serious problems on the local level. Among these are: the local population's ignorance of the new economic rights granted by Russian parliament in Moscow; the seventy-year old habit of relying on Moscow and the state to solve all economic problems; the lingering fear among entrepreneurs that it might be dangerous to operate "in the open" as opposed to the underground "black market."

But the biggest obstacle of all is the unwillingness of the local authorities to allow privatization to proceed — a phenomenon that could be called the "creeping counterrevolution" in Russia. This is much more than an economic problem. Speedy and genuine privatization is a key to the survival of Russian democracy. Without it, the freeing of prices will not fill the markets with goods or control inflation. Without the competition of numerous private enterprises, the old state monopolies simply will charge more for the same shoddy products without increasing productivity or improving quality. If higher prices do not put more goods on the shelves soon, even the traditionally patient Russian people may revolt against the free market policies of the Yeltsin government and precipitate a roll-back of Russian democracy.

---

1 On October 22 the Russian Supreme Soviet passed the law suspending local elections for a year.

To curb this creeping counterrevolution, and to spur privatization at the local level, the Yeltsin government should:

- ✗ Press the Russian legislature to pass laws removing local government obstacles to free enterprise.**

For example, the right of local governments to demand export licenses from businesses should be prohibited. These licenses, which are often required for selling products outside of regions, greatly hinder private business activity.

- ✗ Order local branches of the State Committee for the Management of State Property to use funds from the sale of state property to stimulate growth of private enterprises, help to reduce the 108-billion ruble budget deficit, and to address the needs of the population, rather than to purchase more state property.**

Local branches of the State Committee for the Management of Private Property are tasked by the Yeltsin administration with the sale of state property. However, the funds from the sale often are used for acquiring more property for the Russian government. Instead of expanding the government sector of the Russian economy, the profits from the sale should be used for low-interest loans to private businesses, for reducing the budget deficit, and for local social spending such as soup kitchens, hospitals, and schools.

- ✗ Allocate funds from the central Russian government's budget to enable the President's regional representatives to acquire office space and equipment, and to hire staff and non-government researchers for independent survey and analysis of the local privatization data.**

Although the President's representatives are tasked to expedite privatization in the provinces, they are often handicapped by their dependence on local authorities for office space, equipment, and staff. This makes them hostages to local bureaucracies and, as a result, the Yeltsin government receives a distorted picture of the local privatization effort. It is necessary to allocate special funds to enable the representatives to operate independently of the local authorities.

- ✗ Coordinate the reform efforts of the Russian government and Russian entrepreneurs.**

This would enable Yeltsin's regional representatives, who are the engines of economic reform in local communities, to link up with private entrepreneurs and to form a common front against the intransigent local bureaucracy.

- ✗ Facilitate contact between foreign investors and Russian businesses.**

This would enable local businessmen to form their own contacts with foreign investors and experts, allowing them to bypass local officials who try to steer foreigners to invest in state-run enterprises that they control.

## THE REASONS FOR LOCAL BUREAUCRATIC RESISTANCE TO PRIVATIZATION

Despite the defeat of the August 19 - August 21 Communist coup in Moscow, most of the officials on the local level are former Communist bureaucrats, who are hostile to free market reforms and have excellent connections with bureaucrats of similar background on the national level. They are there because it is impossible to change the entire staff of local and central bureaucracies in the few months that have passed since August.

Local government officials are opposed to free market reforms because they threaten their control over the local economy. Once real privatization occurs, no one would need bureaucrats to manage the economy, and local government power over the population would be much more limited, as it is in the West.

In some places, the bureaucratic resistance to privatization is supported by the population. After centuries of authoritarian czarist rule and seventy years of Soviet totalitarianism, many Russians look to local authorities to solve problems in all areas of life. That is especially true of the economy. Under increasing pressure from the population to overcome food shortages, reduce inflation, and halt the decline in the standard of living, the local authorities who resist privatization argue that the only way for them to fulfill the popular expectations is to directly manage local economic affairs, despite what the central government in Moscow wants.

**Fear of Markets.** Another source of bureaucratic resistance to privatization is the local authorities' fear that a free market would create huge political problems for them. Thus, for example, in the Ural Mountains region and Western Siberia, the lion's share of the population is employed in heavy industry and military production. In many towns, especially smaller ones, virtually the entire population is employed by a single plant. In such areas the local authorities provide food for the population by forcing the peasants on the state-controlled collective farms to deliver their produce at artificially low prices. If the land is privatized, if collective farms disintegrate and the market begins to dictate prices, the local authorities, who have neither money nor barter goods to offer peasants in exchange for food, will end up with tens of thousands of hungry people on their hands. This will lead rapidly to a popular revolt against local authorities. It is precisely this type of revolt that local bureaucrats seek to prevent by opposing land privatization.

Finally, Russian local governments have a direct monetary interest in maintaining intrusive control over the local economy. For example, the local governments serve as mediators between foreign businessmen and local companies. In addition to the income from commissions and bribes, this activity also results in all sorts of junkets abroad. In the Ekaterinburg (formerly Sverdlovsk) region, most of the last year's hard currency budget of the regional government was spent on trips abroad for the officials.

Another source of revenue is licensing of exports. In most areas of Russia, in order to take their goods out of the region, businesses must be licensed by the local authorities. Authorities grant such licenses but only in exchange for a hefty share of a company's profits. Often their share reaches as much as 50 percent of a company's profits.

## **“MUNICIPALIZATION” INSTEAD OF PRIVATIZATION**

Under pressure from the Yeltsin government to privatize, most local governments in Russia try to avoid a direct confrontation with Moscow. Rather, they engage in indirect sabotage of the privatization program. The most common strategy is to create what might be called “as-if” private enterprises, which are in fact owned by the local authorities. This process may be called “municipalization.”

This is how municipalization works: The local government is the owner of most of the local industrial park and land (the rest is owned by the central Russian government). Instead of just selling a factory, a store, a building, or a piece of land to anyone who wants to buy, local officials may offer to lease the property instead. The profit from such “sales” or leases are often invested by local governments in buying more factories, stores, real estate, or land.

**Preferred Business.** In addition to municipalization of state-owned property, the local governments seek to retain control over the economy by subtler means. For example, they set up “private” businesses with municipal or former Communist Party money, which they then give or loan to a trusted “private” entrepreneur who is usually a former member of the local “nomenklatura,” as the occupants of high positions in the Party, industry, or government are called. Because of their past, they have both professional and personal connections to local government officials. It is no accident that in many Russian provinces the owners of the largest “private” firms in Russian towns are members of the local government or their representatives.

These officials and their private partners become owners of what may be called “preferred” businesses, because they receive special treatment from the local government. For example, local governments supply them with such scarce commodities as raw materials, fuel, and transportation. They also get preferential treatment in renting or buying buildings for their enterprises. Local bureaucrats sometimes channel foreign investors their way which enables them to form joint ventures with foreign businesses. While nominally private, such preferred businesses are, in fact, another form of municipalization because they are owned or controlled and manipulated by local bureaucracies.

## **“CREEPING” PRIVATIZATION**

Bureaucratic resistance is a serious obstacle to privatization. It has slowed the pace of privatization considerably. Still, the local governments that are opposed to privatization have failed to stop private economic activity altogether. Instead, it

often assumes abnormal forms. This process may be called "creeping" privatization.

**Speculators.** The moving force behind creeping privatization are the so-called "speculators." In Russian, this term describes someone who buys low, usually from subsidized state-owned store or enterprise, and sells at a higher, market price on the black market, which is essentially free market activity prohibited by law. Because of the perennial shortages, distribution bottlenecks, and corruption inherent in a socialist economy, speculation becomes the only efficient means of bringing quality consumer goods to those willing to pay the market price for them.

Until a few years ago, engaging in any kind of production of goods and services outside the state sector was a criminal offense and meant a prison term. As a result, most of the Soviet private entrepreneurs were forced to become speculators. The situation has changed since private business activity gradually became legalized in Russia in the late 1980s. First, the number of speculators has increased tremendously. The lure of making a lot of money fast and without risking a jail term attracted thousands of young people, most of them under thirty, into this kind of economic activity. Having reached adulthood since 1985, under *glasnost* and *perestroika*, these young businessmen are not afraid of the state and are more prone to take the risks of large-scale transactions than were the previous generations of underground entrepreneurs. Second, unlike older speculators who were forced to hold down a government job to avoid criminal charges of "social parasitism," the new private businessmen work for themselves full time. Many do not have any other profession or trade except making money. Thus, a totally new social class — professional private entrepreneurs — is emerging in Russia.

Because of the slow progress of privatization in Russia, most of these young professional entrepreneurs continue to engage mostly in speculation, or as it is beginning to be called in Russia, "brokering." Unlike their older colleagues, however, many of the new businessmen no longer are content with quickly making a lot of money and then quitting. Rather, they want to make a permanent career of business.

**"Forced" Privatization.** One of the ways in which the young entrepreneurs succeed in wrenching the productive sector of the economy from the hands of local bureaucracies may be called "forced" privatization. Many speculators have accumulated huge sums of money, often as high as hundreds of millions of rubles. At the same time, hundreds of state-owned enterprises, especially in the military and heavy industry sectors, which have few products anyone wants to buy, lack operating capital. Many have problems even meeting the payroll. And local authorities often are unable to help them out because of huge budget deficits.

It is under these circumstances that "forced" privatization takes place. A speculator approaches the manager of a near-bankrupt state plant and offers to invest in it in exchange for a share of the enterprise. Reluctant as the managers may be to "go private," even partially so, they have no choice because they have run out of operating funds. Although slow and gradual, "forced" privatization allows

private entrepreneurs to engage in direct and expanding production activity over which local authorities have little control.

## HOW THE RUSSIAN GOVERNMENT PROMOTES PRIVATIZATION

The Russian central government is well aware of the obstacles to privatization on the local level. To help overcome local bureaucratic resistance, the Yeltsin government uses three administrative tools: 1) direct appointment of Heads of Local Administration governors for the regions; 2) dispatching the President's Representatives to the provinces; and establishing local branches of the State Committee for the Management of Private Property.

**Heads of Local Administration.** On October 22, 1991, the Russian Supreme Soviet (parliament) approved Yeltsin's decree suspending local elections throughout Russia until the end of 1992. The reason: the temporary hardship and dislocation caused by the transition to the free market may cause a political backlash from which Russia's new leftist political forces, which includes former Communists, stand to gain.

Instead, to assure that free market reforms remain on track, Yeltsin began in the fall of 1991 to appoint Heads of Local Administrations to Russia's regions. Several factors, however, seriously diminish the effectiveness of Yeltsin's appointees. First, since they are not elected, they lack legitimacy and are not seen as representing the will of the majority of the local population. Second, in many areas the Heads of Local Administration are up against entrenched, resilient, and politically very skillful local bureaucracies that seek to undermine the privatization effort. That means that even the best intentions and orders of the Head of the Local Administration are likely to be frustrated by passive bureaucratic resistance of their subordinates.

**Presidential Representatives.** Yeltsin began appointing his special envoys or "Representatives" to local governments in the aftermath of the August 19-21 coup. The President's Representatives have the task of reporting to Moscow on the pace of privatization in the regions. In the case of direct sabotage of the free market reform by local officials, the Representatives may even recommend that such officials be fired by the President.

Yet, while they certainly keep pressure on the local authorities to expedite privatization, Yeltsin's private envoys often have neither sufficient expertise nor enough staff to see through and overcome the various ruses and stalling techniques employed by the local opponents of privatization. Such techniques include, for example, municipalization and the special treatment given preferred businesses, which are nominally private but are, in fact, controlled by the local authorities.

Lacking the means to collect and analyze data on the progress of privatization in their provinces, the President's Representatives tend to send to Moscow whatever facts and figures the local bureaucracy gives them, such as, for example, the number of privatized retail stores. Yet many of these stores may be not be

privatized at all, but merely municipalized, or taken over by the city governments. Furthermore, even if privatization is genuine, privatizing retail trade, while important, is not as critical as privatizing industry, real estate, and agriculture. Yet the Representatives often have no data at all about the progress of privatization in these areas. As a result, the picture painted by the Representatives often is misleadingly rosy.

**The State Committee for the Management of State Property.** Created by the Council of Ministers of Russia, the State Committee for the Management of State Property is the main Russian government agency in charge of privatization. It is tasked with selling state property to private entrepreneurs. The term "state property" here describes the property of the central Russian government, as opposed to the property in the hands of local authorities. Usually, state property is what used to belong to all-Union ministries in Moscow, such as, for example, large industrial plants, military plants, factories producing electronic equipment, and trucks.

The State Committee for the Management of State Property has branches in all Russian provinces ("*oblasti*" in Russian). Their task is to sell state property, such as stores, factories, and plants, to private entrepreneurs. There is, however, a serious danger that the proceeds from the sale of the state property owned by the central government will be invested by the local Committees in buying local property, thus making the Government of Russia the owner. As a result, instead of diminishing state ownership of industrial enterprises, the local Committees may, in fact, increase it by adding new assets to the state ownership.

## HOW THE RUSSIAN GOVERNMENT CAN SPUR PRIVATIZATION IN THE REGIONS

The Russian democratic revolution is now in its second, critical stage. The previous phase, that of spectacular political collisions at the top, is gone — at least for the time being. Instead, the fate of Russian democracy is being decided in the difficult daily struggle for free market reforms at the local level, in the fight with the experienced bureaucrats who oppose privatization.

To overcome this resistance and facilitate the transition to free market, the Yeltsin government should:

- ✕ Press the Russian legislature to pass laws removing local government obstacles to free enterprise.**

The names of most of the local bureaucrats opposed to privatization are well known. Yet because many of them have been elected to their positions, the Yeltsin government cannot remove them wholesale without discrediting democracy itself. At the same time, the central government and the Russian Supreme Soviet can change laws, removing some of the most powerful weapons from the arsenal of the local bureaucrats. While waiting for local elections, the Yeltsin government should urge the Supreme Soviet to pass laws outlawing some of the anti-reform activities of local governments.



Export licensing and regional custom checkpoints on exported goods, for example, should be among the first of these activities to be prohibited. If a private business wants to export its product outside of a province or abroad, it must obtain a license. In most cases, the local governments ask for a huge share of profits, often reaching 50 percent, in exchange for the license. If a business refuses to pay and then tries to export its products, the so-called "road control points" along the border of the province intercept and turn back the trucks carrying the exported goods.

Licensing and regional custom checkpoints slow the emergence of a free market in Russia in three ways: 1) they enrich local bureaucracies, thus strengthening their position as obstacles to real privatization; 2) they deprive local private businesses of legitimate and, in many cases, vital sources of revenue; and 3) export controls prevent an emergence of an all-Russian market, in which goods and services are freely exchanged. Thus, Yeltsin's government should ask the Russian Supreme Soviet to pass laws outlawing these kinds of anti-reform activities.

- ✗ Order the local branches of the State Committee for the Management of State Property to use funds from the sale of state property to stimulate growth of private enterprises, help to reduce the 108-billion ruble budget deficit, and to address the needs of the population, rather than to purchase more state property.**

Local branches of the State Committee for the Management of Private Property are tasked by the Yeltsin government with selling the property of the central Russian government to private entrepreneurs. Yet, there is a danger that in many places the Committees will attempt to reinvest funds from sales back into industry, retail, and agriculture, thus increasing the number of state-owned businesses, rather than decreasing it.

There are much better uses for these funds. Most important is to stimulate local private businesses by extending low-interest loans to them. A portion of the money earned from privatization should be spent to close the 108-billion ruble Russian budget deficit and thus help to slow down the 400 percent inflation which devastates the Russian consumer. And the funds could be used to meet social needs, such as opening soup kitchens for the poor, buying medicine and equipment for hospitals, increasing salaries for teachers, and repairing roads. These measures would be extremely popular and increase public support for privatization.

- ✗ Allocate funds from the central Russian government's budget to enable the President's regional representatives to acquire office space, and equipment, and to hire staff and non-government researchers for independent survey and analysis of the local privatization data.**

The task of Yeltsin's representatives to Russian provinces is to expedite free market reforms. However, their effectiveness is seriously diminished by their dependence on the local authorities for material support, such as office space, office equipment, staff, and experts. As a result, in many provinces the representatives

become hostages to the local governments. This dependence jeopardizes the integrity of their oversight.

Making the president's representatives financially independent of local authorities will improve their ability to collect data on privatization and analyze the situation in the provinces. They will be able, for example, to pay independent, non-government research centers and individual experts to conduct in-depth surveys and offer recommendations. This in turn, would mean that the Yeltsin government would receive a more comprehensive and more truthful picture of what is happening in the country.

**X Coordinate the reform efforts of the Russian government and Russian entrepreneurs.**

To overcome the resistance of local authorities to privatization, the Russian government needs local allies. Perhaps its best allies are local entrepreneurs. So far, however, the government has done very little to build bridges to local businessmen, much less to coordinate the efforts with them. For example, the Council of Businessmen created under the Russian government's aegis in January 1992 does not represent the entire Russian business class but only a small part.

In addition to expanding the membership in the Council of Businessmen to include a broader cross-section of Russian entrepreneurs, the Russian government should work to gain the trust of entrepreneurs and secure their assistance. Thus, for example, Yeltsin and his aides should meet periodically with businessmen in the Kremlin to hear their assessment of the economic situation and ask their advice. Likewise, Yeltsin's envoys to the provinces should meet with the representatives of local businesses to assess the pace of privatization, discuss the obstacles to it, and coordinate solutions.

**X Facilitate contact between foreign investors and Russian businesses.**

Foreign investment and joint ventures of Western and Russian entrepreneurs are much more than simply economic transactions. Russian entrepreneurs, who for decades have been forced to operate underground, have very little experience in running legitimate businesses. Business ethics, taxes, property rights, arbitration, labor relations — all these issues are new to them, especially in the provinces. Working directly with foreign businesses or observing how they operate will be an invaluable learning experience that would greatly facilitate free-market reforms on the local level.

The best way to attract foreign entrepreneurs to Russia is to create a most-favored-status for them. Yeltsin's January 23 decree suspending customs tariffs is an important step forward. Further legislation is needed that would contain as few limitations as possible on the scope and nature of the activity of foreign entrepreneurs in Russia. For example, lowering taxes and facilitating repatriation of profits abroad would produce a very beneficial effect.

## CONCLUSION

Boris Yeltsin's bold free market reform program faces many obstacles, but none as threatening as the bureaucratic opposition from local governments. Local government officials subvert privatization in different ways. They may refuse to sell local property to a private entrepreneur. Or they may lease state-owned enterprises to cronies for their private gain. Or they may use the funds gained from privatization to acquire more state property. Whatever their method, they are a menace to Yeltsin's free market revolution and need to be stopped if Russians are to crawl out of the current economic crisis.

This can be done by passing laws that prohibit local licensing of businesses and other obstacles to the free flow of goods and services. Further, funds gained from the sale of state-owned enterprises should not be reinvested in other state-run enterprises, but should be used to extend low-interest loans to private businesses or lower the budget deficit. And the Yeltsin government should bypass local governments when promoting its reforms, encouraging budding private entrepreneurs to form direct contacts not only with the reformist central government, but also with foreign companies which may want to invest in local industries.

The legacy of the communist command economy lives on in the local governments of Russia. It would be a great tragedy if the great democratic and free market revolutions fomented in Moscow were undone by the venality and obstinence of petty officials in the countryside.

*All Heritage Foundation papers are now available electronically to subscribers of the "NEXIS" on-line data retrieval service. The Heritage Foundation's Reports (HFRPTS) can be found in the OMNI, CURRNT, NWLTRS, and GVT group files of the NEXIS library and in the GOVT and OMNI group files of the GOVNEWS library.*

