

December 28, 1993

HOPING FOR THE BEST, PREPARING FOR THE WORST: RETHINKING U.S. POLICY TOWARD RUSSIA

INTRODUCTION

The disappointing outcome of the Russian elections should serve as a wake-up call to the Clinton Administration. The dramatic success at the polls of hard-line nationalist Vladimir Zhirinovskiy, communists, and other anti-democrats changes not only the political equation inside Russia but the nature of U.S.-Russian relations as well. Now more than ever, America must support the reformers in Russia, including President Boris Yeltsin, but it must also prepare for the possibility that they will fail.

While encouraging Russian reformers to stop their bickering and to form a united front against the real threats to democracy—the fascists and the communists—the Clinton Administration must also prepare America's defenses in case Yeltsin and his reformers are ousted from office. To do this, Clinton must reverse the decline of America's defenses, guarantee the viability of the North Atlantic Treaty Organization, and plan to build missile defenses for the continental United States.

Clinton also should offer to enter into a tough foreign aid compact with Yeltsin: in exchange for a refashioned aid package that provides funds for private credit and capital formation and unemployment insurance, Clinton should ask that Yeltsin use his new constitutional powers to push through a rapid and sweeping reform of Russia's economy—far more rapid and sweeping than he has been willing to do so far. With the next presidential election only two years away, the Russian president has only a short time to show some positive results from his reforms. He cannot go backwards. Nor can he slow down, as the Clinton Administration now seems to want. Yeltsin's only choice is to move as quickly as possible toward turning Russia into a market economy.

RUSSIA'S DISTURBING CHOICE

Impoverished and humiliated, the Russian people let out a large cry of protest in the parliamentary elections. At last count, the ultranationalists led by Zhirinovsky received at least 24 percent of the party preference vote, while communists and their allies got around 25 percent. This means that 49 percent of the Russian voters chose extremist anti-democrats on either the right or the left. Overall, the communists and nationalists, with about 177 seats, will outnumber Yeltsin's reformist allies, who will have only about 160 of the parliament's 450 seats. However, because of a strong showing in single-district seats, the reformist Russia's Choice, led by Deputy Prime Minister Yegor Gaidar, will have 103 representatives in the lower house, or Duma, compared to 66 for Zhirinovsky's Liberal Democrats.

While potentially very dangerous for Russia and the world, this result is not too difficult to understand. Since 1990 Russia's industrial production has fallen 45 percent. Strapped with a monthly inflation rate of 33 percent, Russians have seen their savings completely disappear and their standard of living plummet to frighteningly low levels. Few if any countries in the world could withstand this kind of upheaval without showing some signs of demagoguery or seeking a scapegoat.

The causes of Russia's distress are not to be found in some gigantic leap forward to a market economy in the past two years. Russia, in fact, is not a market economy at all. It is a command and control economy in a state of collapse, with emerging private enterprise operating in fits and starts at the fringes of the economy. Despite some progress toward privatization, there is scant evidence that Russia has undergone some sort of "shock therapy," as Yeltsin's and Gaidar's economic policies are sometimes described. To be sure, prices have been liberalized and privatization has begun. But most of the industrial sector and all of the agricultural sector are still state-owned, taxes are extremely high, and regulations and laws governing commerce and investment are impossibly contradictory, confusing, and in most cases downright inimical to private enterprise. Moreover, Russia still does not have a stable currency, which is the hallmark of a market economy. Nor does it have any form of long-term capital market, which also is essential for a market economy.

Russia's progress toward a free market has not been too fast. It has been too slow. Unless this fundamental fact is understood by Yeltsin and his supporters in the West, all bets for Russia making a safe transition to a stable democratic society are off.

Bets on Boris. Until before the elections, of course, all of President Clinton's bets were on one man: Boris Yeltsin. But the outcome of the Russian elections have caused the Administration to rethink this policy. Strobe Talbott, the State Department's Ambassador at Large for Russia and other countries of the former Soviet Union, has said that the U.S. is looking to other reformers as well as Yeltsin to change the country.

There are many reasons why the "Yeltsin only" strategy failed. A number of reformers not only split among themselves, but from Yeltsin as well. The demise of a united reformist front against communists and fascists isolated Yeltsin, diminishing the political significance of U.S. support for him. Moreover, since much of the aid promised by Washington has been held up by the International Monetary Fund, the U.S. has lost some of its leverage over Yeltsin. Caught between hard-line pressures at home and diminishing

political capital from abroad, Yeltsin drifted toward a tougher foreign policy, complaining about the expansion of NATO and continuing interventionism in the countries that border on Russia.

While Clinton has no choice but to continue backing Yeltsin, he must now broaden his policy to encourage the Russian president to create a united democratic front against communism and fascism. This will mean extending a hand to all democratic reformers, including some of those who oppose Yeltsin. But it will also mean encouraging reformist opponents of Yeltsin such as Grigoriy Yavlinsky to end their squabbling with the president, whom they accuse of wanting to become a "dictator." It should be clear to all that the real threat of dictatorship comes from Zhirinovskiy and his ilk, and not from Boris Yeltsin. It is vitally important that Russian democrats and market reformers put aside their personal differences and unite against the common threat of extremism on the left and the right.

It also is important that Clinton warn Russians that a return to dictatorship and imperialist expansion will come at a heavy price. America and its allies, who are now much stronger than Russia, will oppose any attempt to expand Russian power unilaterally beyond the borders of the Russian Federation. A revanchist and expansionist Russia will be isolated politically, economically, and militarily. The consequence of this isolation will be palpable and painful: more grinding poverty, political repression, and grave insecurity for the Russian state and its people.

AN INSURANCE POLICY: STOP THE FREE FALL OF DEFENSE

If the democrats were to fail, and Russia were to embark again on an expansionist course in foreign policy, America would once again face a threat to its security. The U.S. must be prepared in case this happens. This cannot be done if President Clinton continues his assault on the defense budget. Clinton plans to cut defense by 41 percent by 1998. But more reductions surely are on the way. Earlier this month, Secretary of Defense Les Aspin admitted that he had underestimated the cost of his five-year defense plan by \$50 billion. To make up for this budget shortfall, Clinton will shrink the size of U.S. forces and not ask Congress for more money.

These cuts are already undermining the combat readiness of U.S. forces. The Army alone needs at least \$1 billion more than budgeted this year to modernize its weapons and equipment. For the first time in ten years, moreover, around 90 percent of the Marine Corps' equipment is not ready for use in combat. And finally, because of budget cuts, the Navy has a backlog of 150 aircraft and 250 aircraft engines in need of maintenance. These are the telltale signs of an armed force that is rapidly becoming hollow and weak.

Clinton's defense reductions are also ending any chance of protecting U.S. territory against nuclear attack. Secretary Aspin proposed in the "Bottom-Up Review" to trim the strategic defense budget by over 50 percent during the period 1995-1999. Further, he recommends cutting by 83 percent the space-based defense program that would protect America from the kind of long-range missiles deployed in Russia.

It makes no sense to give up the ability to defend America against nuclear attack if in two years someone like Zhirinovskiy could have his finger on the Russian nuclear button. Even if that nightmare scenario does not occur, the prospects are high that some form of

anti-Western figure, whether communist or fascist, will emerge as a leader of Russia if Yeltsin fails.

The hemorrhaging of the defense budget must stop now. If the current rate of decline continues, U.S. defense capabilities will be dramatically weakened. If current trends continue, it will take years to rebuild U.S. forces if a Russian threat should reemerge. This is a risk America should not be taking. To restore America's defense readiness, the Clinton Administration must commit to spending at least \$280 billion a year (in constant 1993 dollars) for the next five years, Current plans are to spend an average of less than \$260 billion per year.

Strengthening NATO. To check a revanchist Russia, the U.S. should encourage important Central and Eastern European countries to make the political and economic reforms needed so they can join the North Atlantic Treaty Organization. Poland, Hungary, and the Czech Republic suffered fifty years of Soviet domination and should be given the opportunity to join the family of nations NATO represents. The Clinton Administration's "Partnership for Peace" plan to include these countries in NATO takes the correct approach—for now. These countries will be encouraged to become partners and learn the obligations of membership. The U.S. should actively encourage these nations to build the necessary military forces that can contribute to European security without being a burden to NATO. Should the pace of reforms in Russia fail to stem radical nationalism, the U.S. must consider offering security guarantees to these countries on a more accelerated timetable than the Partnership for Peace currently envisions.

Poland, Hungary, and the Czech Republic have begun making the difficult political, economic, and military reforms NATO membership would demand. No country that has been unwilling or unable to do so should be rewarded with the security guarantees that NATO provides. Thus, neither a nuclear Ukraine nor an expansionist Russia should be eligible for any formal relationship with NATO.

Far from being a bulwark against a revanchist Russia, Ukraine could become an albatross around the neck of the West. Having Ukraine as a full member of NATO or any other Western security organization would dangerously overextend NATO's eastern front, possibly entangling it in conflicts which it wishes not to fight and which are not critically important to the security of Europe. The result, therefore, could be less security for Europe, not more. However, having Ukraine as a mere "partner" of NATO—as an associate of the alliance that does not enjoy security guarantees—would be acceptable if Ukraine were to become fully democratic. Unfortunately, that condition cannot be met today because Ukraine's record on reform is much worse than Russia's.

Russia should be allowed to become a "partner" of NATO, as envisioned in Clinton's Partnership for Peace, but only so long as that country continues with its democratic and market reforms. Russians should have nothing to fear from NATO so long as it remains committed to international agreements and refrains from an expansionist course against its neighbors.

A NEW AID COMPACT WITH RUSSIA

These preparatory measures should provide some insurance in case Yeltsin and the reformers fail. But Clinton should not sit on the sidelines simply preparing for the worst. He must also do something to give hope to Russians and the rest of the world.

Clinton should urge Yeltsin to use his new presidential powers, granted by the new constitution, to enact a sweeping campaign of economic reform. Yeltsin has only two years before the next presidential elections, and he must show some economic results before that time. Otherwise Zhirinovskiy and other radicals will continue to benefit politically as the country slides further into economic chaos. Some reformers and "centrists," of course, want Yeltsin to go slower on reform. But they must realize that postponing dramatic reform will only make matters worse, prolonging the agony, and practically ensuring the election of an anti-reformist and possibly extremist president in 1996.

Working with the G-7. To ease the blow of dramatic change, and to speed economic reforms, the U.S. and other donors should change their aid policies. They must abandon the course advocated by the International Monetary Fund, whose advice focuses on government-imposed fiscal austerity rather than entrepreneurial-driven economic expansion. What former U.S. Housing and Urban Development Secretary Jack Kemp has said about the American economy is certainly true for the Russian economy as well: Austerity is not the answer. What Russia needs is not a dampening of the entrepreneurial spirit, but rapid economic growth and development. Thus, instead of following IMF advice and asking Russians to raise taxes to balance budgets, or to focus on government-led economic recovery, the U.S. should bypass the IMF and work directly with the Group of Seven (G-7) industrialized nations to form a new aid policy toward Russia.

This aid package should come in the form of a compact between the West and Yeltsin's government. From Russia, the West would ask for guarantees of more rapid privatization, lower taxes, fewer regulations and restrictions on foreign investment, the creation of commercial codes and other legal protections of private property, a tighter monetary policy, the end of mass subsidies to money-losing state industries, and the creation of a sound and convertible currency, either through an independent central bank or a currency board. In return, the U.S. and its allies would offer an aid package that focuses on creating credit and capital for private companies and unemployment insurance for those who have been thrown out of work by the restructuring of the economy.

Unemployment Insurance. New enterprises in Russia desperately need credit and operating capital. Certified private banks in Russia could use Western funds to finance the formation of privately owned and operated small and medium-size businesses. As for solving the industrial subsidy problem, the political threat posed by the skyrocketing unemployment rate could be diminished if the G-7 nations helped to create a privately run unemployment insurance fund. Millions of people will be thrown out of work as inefficient and uncompetitive industries are closed. To cushion the blow, the newly unemployed could receive either a one-time severance payment or a paycheck for a couple of years until they can get a new job. The success of this program would depend on the elimination of the residence permits issued by the police, which hamper freedom and movement and the mobility of labor, and on the privatization of housing and the creation of real estate markets. Success also would depend on an influx of funds from the Russian

government, which they could direct from existing subsidies to fostering the private sector.

The unemployment insurance fund would solve not only a political problem—what to do with the temporarily unemployed as inefficient industries are shut down—but an economic one as well. By propping up industrial dinosaurs, the current system of state subsidies ties up both human and physical capital. Not only are large state-owned enterprises a tremendous drain on the state budget, but they lead to scarce capital assets in Russia being used in an extremely inefficient and unproductive way. These assets—equipment and buildings—are thus denied to entrepreneurs who would use them more productively. By the same token, they trap vast armies of workers within unproductive enterprises, depriving the more productive private economy of their valuable labor.

Productive Use of Capital. By closing down these enterprises, both human and physical capital would be freed for more productive purposes. And, of course, by ending state subsidies, there would be less pressures to print money. Thus, there would be less inflationary pressures on the economy. Moreover, the remaining physical assets of the enterprises—equipment and the like—could be sold off to Third World countries for cash. This money could also help to balance the budget.

An unemployment insurance system does, of course, continue to subsidize labor—which is being subsidized now. But it allows change to take place by permitting unproductive physical capital to be used differently and by making labor available for other opportunities.

This approach to ending subsidies to state enterprises is not perfect, of course, and it involves risk. Unemployment insurance costs would go up, albeit temporarily, and there would always be a danger of creating a self-perpetuating welfare system. For this reason, it is important that government assistance be of limited duration. Moreover, in the end, what matters most to Russia's future prosperity are reforms, not aid. But the present system is far worse. With this new approach, the overall budget deficit would fall because the unemployment insurance costs would be less than those needed to finance inefficient and loss-making state-owned enterprises.

To minimize corruption, the credit and unemployment insurance funds could be managed by private Western or private joint-venture firms that are monitored by a state committee comprising members from the G-7 donor nations and the Russian government. Under no circumstances should aid be given directly to state or governmental organizations in Russia. The money will only end up wasted or in the pockets of corrupt officials and old Communist Party *apparatchiks*.

The U.S. and the G-7 nations, moreover, could give aid directly to private firms that build highways, railroads, grain elevators, canals, and airports. The West also could help to construct state-of-the-art nuclear plants to replace the old, dangerous ones.

Russia, in fact, has much wealth that is not being used to build the country's economy. Around \$20 billion has been smuggled out of Russia since 1991 and placed in Western accounts. Before that \$40 billion to \$50 billion left the country during the Gorbachev years. This money could be kept in Russia and harnessed for capital formation if the economy were not so restricted by the old system. As a matter of fact, if this money were to be returned, Russia would have no need for foreign aid.

To be sure, U.S. aid to Russia should be made contingent not only on progress toward democratic and market reforms, but on its foreign policy as well. If Yeltsin should succumb to communist and fascist pressures and turn Russia into a threat against its neighbors, Washington should cut off aid.

CONCLUSION

There is cause for concern, but the outcome of the elections should not cause Americans to panic. Boris Yeltsin is still fully in charge, and ironically, the presidential powers granted by the new constitution will not only prevent Vladimir Zhirinovskiy and other extremists from controlling Russia any time soon, but make it more difficult for them to influence policy in the meantime. Moreover, despite the setback in the elections, nearly half of the Duma and most members of the parliament's other chamber, the Federation Council, are reformers and centrists who do not want a return to communism or the creation of a fascist state.

But only the foolhardy would conclude that business should continue as usual. While not necessarily a call to arms, the Russian elections should be a call to action. Time is running out for reform in Russia. Unless something dramatic is done to show that democracy and market reforms can produce a better life, Russia will once again become a threat to itself, its neighbors, and the world.

Kim R. Holmes
Vice President and
Director of Foreign Policy and Defense Studies

All Heritage Foundation papers are now available electronically to subscribers of "Town Hall," the conservative meeting place, and "NEXIS," the on-line data retrieval service. For information about Town Hall services, please call 1-(800) 441-4142. On Nexis, 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.