CHAPTER 3

THE TASK AHEAD: CREATION OF A FREE ENTERPRISE SYSTEM AFTER A CENTURY OF STATE CONTROL

AP Photo/J. Scott Applewhite

FROM THE BERLIN WALL TO THE INVISIBLE WALL: "General Secretary Gorbachev," President Reagan asked at the Berlin Wall, June 12, 1987, "if you seek peace, if you seek prosperity for the Soviet Union and Eastern Europe, if you seek liberalization: Come here to this gate! Mr. Gorbachev, open this gate! Mr. Gorbachev, tear down this wall!" The Berlin Wall fell, but at the outset of the Clinton and Yeltsin administrations, an invisible wall of high tax rates, limited market competition, weak contract and property rights, and no real banking system confined Russians. Clinton policy reinforced this invisible wall with bad economic advice that contributed to Russia's economic collapse in 1998. Trade with the Communist-controlled People's Republic of China was a higher priority than trade with Russia. Tax collections were emphasized over rate cuts. Government-to-government loans substituted for growth policy. Capital flight undermined investment in Russia. Predictably, Russia's economic output plunged 40%. Clinton policy contradicted advice from President Reagan in his Berlin Wall speech: "In West Germany and here in Berlin," the President said, "there took place an economic miracle, the Wirtschaftswunder. Adenauer, Erhard, Reuter, and other leaders understood the practical importance of liberty—that just as truth can flourish only when the journalist is given freedom of speech, so prosperity can come about only when the farmer and businessman enjoy economic freedom. The German leaders reduced tariffs, expanded free trade, lowered taxes. From 1950 to 1960 alone, the standard of living in West Germany and Berlin doubled."

For 72 years, Communism in Russia waged a silent war against the human soul. Sometimes screams were heard from torture chambers deep in prisons and in detention centers, but mostly the war was fought with ideas and incessant public propaganda ... Communism ... wounded the habits of honesty and trust, self-reliance and fidelity to one's word ... The transition from Communism to a free society is consequently a severely demanding moral task ... How that transition goes is perhaps the greatest issue of our time.

Michael Novak, writing in *Commentary*, June/July 2000

Economic science adds that the more successfully private business is run in society and the more (so to speak) whole coats there are, the firmer are its foundations and the more the commonweal flourishes. Thus, while busy acquiring only and exclusively for myself, I actually, at the same time as it were, acquire for all and help bring about a condition in which my neighbor receives something more than a torn coat. And he receives it not from the private charity of a few but as a result of overall improvement. The idea is a simple one. Unfortunately, it has been too long in reaching us.

Fyodor Dostoyevsky, *Crime and Punishment*, 1866

Without justice, what is the state but a band of thieves?

St. Augustine, *The City of God*

The English philosopher John Locke argued that the essential function of government is to protect life, liberty, and property. The Soviet Communist system—which killed at least 20 million Russians, denied freedom of thought and expression, and confiscated property—turned Locke's prescription upside down.[1]

The task facing the Russian people in January 1992 was to replace Communism with a free enterprise system and a democratic government that would protect life, liberty, and property.

The collapse of Communism in Russia ended not only the Soviet police state, the gulag, the one-party dictatorship, and the monopoly of state-controlled media but also the Soviet centrally-planned economy. The *perestroika* of the last Communist Party General Secretary, Mikhail Gorbachev, had been an effort to refine, not to replace, the command system of the Soviet Union. But now, in January 1992, there was for the first time in the experience of most living Russians a genuine opportunity to build the foundations of a free enterprise system.

The necessary bricks for that foundation were clear enough:

- Market-determined prices and production
- Binding, enforceable private contracts
- Individual ownership rights in land
- Private mortgage lending
- Commercial banking
- Uninhibited individual investment in for-profit enterprises
- Taxes light enough to minimize tax penalties on work, savings, investment, and risk-taking

The question was not whether, but where—and how—to begin.

A Dysfunctional System

The economic system in Russia at the dissolution of the Soviet Union was fundamentally dysfunctional because the state attempted to control far too many aspects of life. Whereas in Eastern Europe for some 45 years Communism had been superimposed on largely market economies, in Russia Communism had been in place for the better part of a century, and had been imposed on a society with comparatively little experience of free markets.

Any small private farms that had existed before Communism in Russia were brutally collectivized. In Stalin's phrase, the people who owned the farms were "liquidated as a class"—and often as individuals. In Poland, by contrast, small, privately-owned farms survived the post-World War II imposition of Communism: by some estimates, 30% of the Polish economy was privately controlled even during Communist rule.[2] The seeds of free enterprise in Russia would be planted on less fertile soil.

According to Nina Khrushcheva, granddaughter of Soviet dictator Nikita Khrushchev: "There could not have been a culture more out of touch with Adam Smith."[3] Acting prime minister Yegor Gaidar put it this way: "[A]fter seven decades of a regime for which private enterprise was not merely a dirty word but a criminal act...[t]he hostility toward private property permeated all of Soviet legislation and law enforcement."[4]

The Soviet economic bureaucracy in Moscow made decisions for 270 million people inhabiting eleven time zones. Soviet planners constructed an economy devoid of individual initiative and dominated by military spending. Individuals in the Soviet Union who sought to earn a profit were subject to imprisonment for the crime of "speculation." Central planning affected all aspects of the individual's life.

To move from this vast state-controlled economy to a free enterprise system based on private property, markets, and individual choice called for change on a breathtakingly large scale.

For the government, there were three main tasks:

- Soviet-era laws and regulations governing commerce would have to be repealed—not just in Moscow, but in each regional legislature.

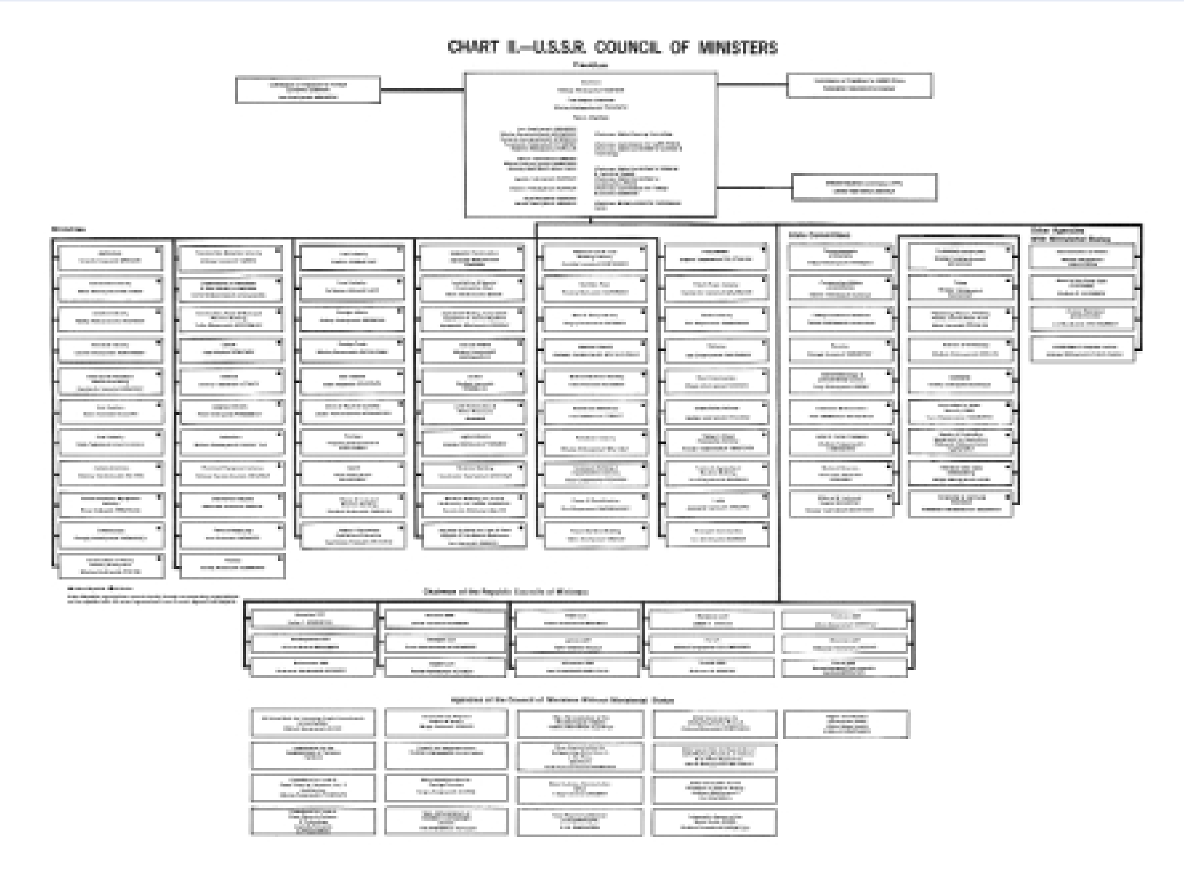
AP Photo/Damian Dovarganes

SMITH BURIES MARX: Nina Khrushcheva, the 32-year-old granddaughter of the late Soviet Premier and Cold War leader Nikita Khrushchev, signs autographs with President Nixon's grandson, Christopher Cox, for visitors July 28, 1996 at the Richard Nixon Library and Birthplace in Yorba Linda, Calif. In the background is a photograph of Khrushchev with Nixon. While her grandfather told Nixon "we will bury you," Nina Khrushcheva noted that the challenge facing Russia at the outset of the Clinton administration was that "there could not have been a culture more out of touch with Adam Smith."

- New legal protections for private property and private contracts would have to be enacted.
- The courts would have to build public confidence that privately-made contracts would be binding and enforceable.

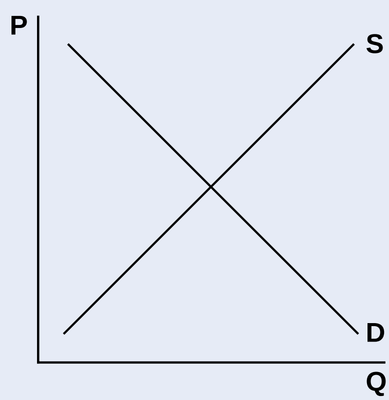
Critiques of the reform process in Russia have often centered on a handful of generalities. Analysts of all ideologies decry the lack of "transparency" in Russian regulation, the need for the government to establish the "rule of law," and the need for the government to build efficient "institutions." In testimony before the House International Relations Committee in September 1998, then-Deputy Treasury Secretary Lawrence Summers repeated these formulations. However, the economic challenge that faced Russia in 1992, *and continues today*, is not simply to establish a better-working government. It is to fundamentally shift the responsibility for economic activity away from the government, and to individuals.

From Gosplan to Supply and Demand



Soviet planning chart courtesy of Congressional Research Service

Before Russia could prosper, the complex Soviet system, a portion of which is reflected in the chart above, had to be replaced with the elegantly simple market system of supply and demand, depicted below in a graph familiar to all students of introductory economics. Russians eliminated the Soviet planning bureaucracy, which included 50,000 territorial administrative units, but other prerequisites to prosperity, including competition, enforceable contract and property rights, and efficient debt and equity markets, were delayed. "Privatizing" Russian assets before the creation of a market economy, rather than after, left individuals and firms unable to transmit accurate supply and demand messages to each other, which in turn caused economic contraction instead of growth.



P=Price Q=Quantity S=Supply D=Demand

Transparency, the rule of law, and efficient institutions indeed are all vital elements of a well functioning free enterprise system. But they can also be consistent with statist economic systems, from Communism to Fascism to Socialism. What distinguished the Russian predicament in 1992, and required remedial action above all else, was that private economic behavior and private property had for so long been illegal.

Russia's task would be to focus all its energies on building the foundation for private initiative in place of government involvement in the economy. These historic circumstances demanded that the central government be cut down to size, and private enterprise legalized and encouraged.

Tearing Down the Soviet Network

The Russian economy was divided into about 200,000 state-owned enterprises. Of these organizations, about 600 gigantic industries were responsible for 47% of the Soviet Union's non-military industrial production.[5]

For most of these industries, competition was nonexistent: they enjoyed a state-enforced monopoly in particular markets. The management of these firms was uninvolved in the strategic decisions normally made by a company's executives. Instead, central planners in Moscow determined quantity and quality, chose suppliers and distributors, and decided what markets were open to industry. This reduced management to little more than production foremen.

During the final months of the Soviet Union, control over enterprises had in some cases been partially devolved to governments in the republics, complicating the prospects for privatization by giving multiple and competing levels of government claims on controlling the privatization of particular industries. In many cases, the resulting limbo left local plant managers and workers in control of factories regardless of the nominal ownership.

The inertia of 70 years of central planning kept producer-supplier relationships in place, despite the collapse of government-organized payment arrangements.

The "privatizations" of the 1990s would later fail to disintegrate the network of inefficient supplier relationships established under the Soviet command economy. This was true in part because the management remained the same, but just as importantly, because the *incentives* to change were missing.

Thus, the Soviet enterprise network continued to operate in essentially the same manner even after the fall of the Soviet Union. Products were still produced in qualities and quantities unrelated to market realities. And while a market economy would have quickly bankrupted inefficient companies that consistently lost money, in Russia these companies continued to limp along, often through continued state subsidies.

The European Bank for Reconstruction and Development later reassessed the first years of economic reform in Russia and Eastern Europe, concluding: "The consequences of the privatization strategy adopted in Russia have been highly adverse for the governance of enterprises and the allocation of resources, not least because of the clear failure to break the political constraints on restructuring and company closures."[6]

"Privatization" is impossible without a functioning market economy into which formerly state-owned assets can be sold. Nonetheless, throughout the 1990s both Russian policy makers and their American advisors (who should have known better) rarely concerned themselves with doing the government's part to establish a market economy. In a free enterprise system, government referees the game, but it is not a player. In the Russian "privatization" scheme, the government relinquished only some of its rights to play the game, and it continued to call too many—and sometimes all—of the plays. As a result, the "privatized" Russian enterprises lacked the normal incentives that cause the efficient allocation of resources in free markets.

Without enforceable property rights, the proprietors of "privatized" firms lacked the incentive to run companies efficiently and in accord with economic reality. Instead, producing profits for the firm's owners often required flatly illegal conduct. The government's continued subsidies for industry only encouraged such conduct, by providing opportunities for owners to strip away assets for their own personal profit, without market discipline.

The task in 1992 was to tear down the Soviet enterprise networks and provide neutral, pro-competitive rules to permit individuals to build new firms in an expanding market. "Privatization" without genuine private property and authentic markets could not accomplish this task.

Establishing Private Property Rights in Land

In 1991, the Russian language did not even have a word or term that captured the essence of private property in land, underscoring how alien this notion was to the Soviet system. Property belonged to everyone, and therefore to no one. As a result, incentives to maintain and enhance the value of real property were absent in Soviet-era society.

The lack of any legal, cultural, or customary basis for private property in land in the Soviet system stifled initiative, suppressed entrepreneurship, wasted valuable human and physical capital, and contributed significantly to the ultimate collapse of the Soviet Communist regime.

In 1991, the Soviet state owned an estimated 1.5 trillion acres of arable land. Breaking the state monopoly over real property was an important first step to allow Russians to use it to generate real wealth. Beyond de-collectivization of the massive state farms and the "privatization" of state-owned industry and housing, a means was required to distribute land to Russian citizens who for decades had been deprived of the opportunity to own it.

The enormous task of moving vast acreages of Russian land from state control to private ownership was not unprecedented. The United States faced a similar challenge in the 19th century. By the 1850s, America's huge land acquisitions had left the government in control of over half of the continental United States. Transferring government-owned land west of the Mississippi River to private ownership became an enormous—and urgent—project.

In 1862, President Abraham Lincoln signed the Homestead Act, one of history's most notable examples of establishing private ownership from scratch. The Homestead Act allowed each citizen to claim one-quarter square mile of surveyed government land for his home, as long as he improved it with a dwelling and grew crops. If the owner maintained the property for five years, permanently clear title was issued.

The Homestead Act and subsequent laws succeeded in transferring vast portions of the United States from government control to private individuals in less than 20 years. Settlers first built homes of sod, which were soon replaced by frame and brick houses. The private property owners invested in trees to shield their dwellings, windmills to pump water from underground, and a host of technologies that made farming profitable. This remarkable transformation of prairie to developed real property was only possible through the establishment of a key element of the free enterprise system: individual ownership of land.

With such vast portions of the Russian Federation under state control, Russia required legislation that would do for it what the Homestead Act did for America almost 150 years ago—not only for residential and agricultural land, but for real property that might be put to any use.

Even more basic prerequisites for establishing private property rights in land were accurate surveying as the basis for certainty of title and public registration of ownership, so that others know who owns what. For property ownership to be useful to individual Russians, titles would have to be open to public inspection and well settled, with no "hidden" state or private claims or rights against the property.

A registry of deeds traditionally serves this function, although in today's global economy it is easy to imagine that a private registry on the Internet or some other form of up-to-date database could just as reliably catalogue real property ownership. The only essential is that title be unshakable, readily transferable, and useful as collateral for loans. Any number of public or private solutions would suffice, so long as the process was precisely accurate and trustworthy.

The owner of land must be able to sell his property on his own, without seeking anyone else's permission—including that of the government. The owner of real property must also be able to use it as security or collateral to borrow money. That, in turn, requires that the lender have a speedy, legally reliable, and inexpensive way to acquire ownership of the property if the borrower defaults. To this end, Russia's regional governments would need to enact laws clearly defining every one of these aspects of ownership.

Finally, because "rights" in land are useful only if they are enforceable, Russia would need to establish a court system that could be trusted to enforce protections for private property owners simply and cheaply.

Establishing private property rights in land was one of the most important elements of building a free enterprise economy in place of Communism that Russia needed to undertake in 1992. By doing this, the destructive linkages to the remnants of the Soviet system could be cleared away, and the vast potential wealth in Russian land could be opened up as a source of start-up capital for individual enterprise.

Establishing Private Property Rights in Housing

Converting the existing stock of Soviet-era state-owned housing to private ownership, and legalizing the construction of more and better housing, was likewise an essential first step to build a successful free enterprise economy. The housing shortage in Russia in 1992 was symptomatic of the inherent problems of the Soviet system, including restrictions on business and individual ownership of residential real property.

The pseudo-privatization of Russian apartments illustrates the difficulty that both the Soviet and Russian political systems had in recognizing basic ownership rights. Just before the end of the Soviet Union in 1991, Russia had allowed some of its citizens to "own" their apartments at little to no cost. (By the end of 1993, 90% of Moscow residential property was theoretically "privatized" in this way.) But such "private ownership" was illusory.

Buying and selling apartment units was legally and economically difficult or impossible. Soviet-controlled rents—frozen since 1928—covered less than 5% of the operation costs. It was therefore impossible for "owners" to pay for property improvements.

The problem was exacerbated when the government, which remained the landlord for "privatized" housing, stopped paying for maintenance for newly-privatized apartments. Because their occupants did not truly "own" them (in the sense that an investment in improvements could translate to an increase in the owner's wealth), the apartments quickly fell into disrepair.[7]

Nor had the government nominally gotten out of the ownership picture; in fact, it had devolved the housing assets and responsibilities to municipalities as a way of relieving itself of the burdens of managing the apartments.[8]

The underdeveloped legal system that existed in 1992, with multiple overlapping jurisdictions and poor enforcement, was yet another contributor to the lack of a housing market in Russia.

Not only were the Russian Federation's property laws—the legacy of Soviet Communist ideology—hopelessly restrictive and confusing, but also the courts were unwilling or unable to resolve the conflicting mandates from federal, regional, and local authorities. A "war of laws" began as various levels of government passed conflicting mandates.

Nor was there any mechanism for resolving such conflicts.[9] Statutory contradictions were left for individuals to resolve, with no recourse to any impartial interpretation of a person's rights or responsibilities under the law. Thus, the profitable use of residential real property was subject to arbitrary restriction, with little or no protection from the government.

In addition to the need for genuine privatization of housing, Russia needed private banks that would create a market in mortgages. In order for ordinary Russians to afford to buy an asset as expensive as a home, a convenient payment system over many years would be needed. The requirement was for a marketable mortgage with a term of 20 to 30 years at a reasonable interest rate.

In 1992, Russia had none of these things, and thus enjoyed none of the benefits of a free market. Little new housing was being created nor old housing sold. No new wealth was created in real estate. The absence of unassailable land titles, the absence of mortgage finance, the lack of unfettered rights to set prices for rents and for property itself—coupled with continued restrictions on the right to alienate real property—amounted to no free market at all.

The lack of a viable mortgage lending system had consequences well beyond a lack of adequate housing: it deprived Russians of their most likely means of generating start-up capital for new enterprises. The only significant tangible asset potentially available to the average Russian was the home he or she occupied (and perhaps nominally owned). Mortgage finance could turn that home from merely a maintenance cost into an asset useful for generating wealth—an asset that has been the stepping-stone to the American Dream for generations of Americans working their way into the middle class.

If a competitive home mortgage industry were at work in Russia, first thousands, and eventually millions, of Russians could use their homes as collateral for small-business loans, creating the entrepreneurial competition needed to break up the Soviet enterprise network. Lacking this normal vehicle for supporting the nascent entrepreneurial class, however, the most entrepreneurial Russians were increasingly being forced to turn to illicit means to fund new businesses. The rest just didn't start businesses at all.

As much as any other factor, the inability of ordinary Russians to use their homes as a means to build businesses has slowed the creation of a broad middle class in Russia, and the realization of the economic and political benefits that it would bring.

The British magazine *The Economist* summed up the challenge for the development of competitive markets in Russian housing and mortgage finance:

> Badly constructed houses, feckless owners, buyers with impenetrable personal finances, an untested legal environment, crooked and incompetent banks, and almost universal political interference in the economy. The reasons behind Russia's lack of mortgage lending are hardly mysterious.[10]

This well described the situation in 1992. Sadly, however, *The Economist* diagnosis was made eight years later in 2000. Nothing had changed.

Making Contracts Enforceable

Yet another basic building block of a free enterprise economy is the freedom to make private contracts, coupled with an effective mechanism for their enforcement. In 1992, Russians had neither.

Because Soviet enterprises were fully government-owned, the need for a fast, efficient, inexpensive, and fair system of resolving commercial disputes between private individuals and firms had never been recognized in the Soviet Union. Contracts between state-owned enterprises were relatively easily enforced: once a dispute was resolved by the appropriate government entity, the loser had little choice but to accept the judgment and act accordingly.

In most cases, moreover, the contracts themselves were dictated from higher levels—so neither party was in a position to question them.[11]

In 1992, recognizing that a sturdy and reliable system of dispute resolution would be required to handle commercial disagreements between private parties, Russia enacted an arbitration code and established local arbitration tribunals throughout the country.[12] But this was not nearly enough: most Russian courts had no experience with arbitration awards, and they were often uncertain of the procedures required.

As a result, while the new law endeavored to legitimize private contracts, it failed in practice to guarantee truly useful contract rights.

Even when a court or arbitration panel could be made to stand behind a contract, the court's judgment was usually very difficult to collect. According to American analysts writing at the time, "the process of identifying, seizing, and converting the assets of the Russian party [against whom a contract judgment was rendered] to cash … [was] likely to be tedious, time-consuming, and expensive."[13]

Moreover, without clear-cut property rights in land, buildings, and housing, few Russians owned any marketable assets that could provide the basis for enforcing a judgment in a private dispute.[14]

Russian firms attempting to operate in this environment in 1992 coped with the challenges through a variety of means, including "blacklists" of unreliable suppliers,[15] penalties imposed by Russian membership organizations,[16] and the use of organized crime groups as bill collectors and contract enforcers.[17] These options were not readily available to foreign firms, however, with the result that the lack of enforceable contract rights served as a significant impediment to foreign investment in the Russian economy.[18]

Private Commercial Banking

Just as clearly defined property rights are essential to creating assets of real value, establishment of a private, competitive, legitimate, accessible, and reasonably-priced retail commercial banking system is vital to creating entrepreneurial opportunities.

Without private commercial lending, neither startups nor expansions of businesses could occur. And without the competition of new businesses, the Russian economy would forever remain captive to the network of formerly state-owned enterprises.

The banking system that Russia inherited from the Soviet Union performed none of the normal functions assigned to banks in the West. Instead of accepting deposits and using those deposits to make loans, Soviet banks acted as the financial arm of the government and of Gosbank, the Soviet Central Bank.[19]

Rather than make loans based on objective analysis of creditworthiness, Gosbank distributed and reallocated resources to favored individuals, companies, groups, and industries at the direction of the state.[20] The Soviet government also used Gosbank as a means to enforce quotas and production requirements, and its bank balances were a prime means for Moscow's economic planners to determine if their targets had been met.

Ending this role for the central government and enacting sturdy, understandable, and pro-competitive banking rules was thus of utmost importance in 1992.

Foremost in establishing a pro-competitive banking system is that banks must be able to maintain an arms-length relationship with industry. This is necessary to allow individual banks the ability to concentrate on the normal banking business of risk analysis, rather than on the implementation of government-dictated economic policies, the subsidization of favored individuals or organizations, or the management of industrial conglomerates. It is also important to avoid the perception of insider dealings between the banks and the companies.

In the Russia of 1992, there was ample evidence that no such arms-length relationship existed, and that neither the banks nor the government could be counted upon to obey or neutrally enforce transparent rules. In 1991, the Russian Supreme Soviet had passed a law mandating that savings accounts be indexed for inflation if prices were liberalized. However, when prices were decontrolled in January 1992, the law was ignored with impunity by the state-owned banks then operating in Russia. Over the next several months, 99% of the savings of the Russian population were lost.

Yet another challenge for Russia was to establish transparent accounting standards as a means of building public confidence in the banking sector.

For private commercial banks to begin the normal business of banking—that is, accepting deposits and making loans—the bankers themselves would have to be assured that they could make loans with the assumption of only a reasonable risk. For this reason, too, Russia needed to establish real property rights in law, honest and efficient courts, and legally useful means to enforce court judgments, so that bankers could use land and buildings as valuable collateral.

Finally, Russia would need to convert its Central Bank into an independent entity charged with setting monetary policy independent of political needs. This would establish confidence among the Russian public and foreign investors that they would be protected against capricious changes in the value of their currency, and from official corruption, thus encouraging deposits in the banking system and discouraging capital flight from Russia.

Repeal of Soviet-Era Regulations

The regulatory structure in the Soviet Union was omnipresent, allowing little deviation from state-determined norms. In 1992 the new Russian government inherited this panoply of regulations, and one of its first challenges was to repeal them. So long as Soviet-era regulations remained in place, there could be no free enterprise in Russia.

The regulatory regime that Russia inherited from the Soviet Union was nowhere more pronounced than in the control of prices—the primary mechanism by which Soviet planners had attempted to control all other aspects of production.

Government-administered pricing hurt both the quality and quantity of products. Prices were often so artificially low that firms faced a choice between producing inferior goods, to keep costs in line with the low prices, or producing goods of passable quality in quantities insufficient to meet public demand. In other cases, by arbitrarily setting prices too high for consumers, the government intentionally (or sometimes accidentally) decreased consumption.

Decontrolling prices was necessary to permit the economy to produce the high-quality goods and services the Russian people needed. Just as important, price liberalization would have to be across-the-board to avoid further disrupting the market.

As if to illustrate the latter point, partial price liberalization was undertaken in 1992. It injured and confused the public, for example, by creating anomalies where the prices of some goods that had not been decontrolled rose in spite of government restrictions. Meanwhile, prices for some other goods that had been decontrolled remained stable, due to pricing by the market, while other decontrolled items soared in price.[21]

A series of export restrictions that limited firms' access to international markets further undercut the potential competitiveness of Russian firms. These regulatory impediments to reaching overseas customer markets made stripping a firm's assets more profitable than using them productively.

Regulations also forced the repatriation of export earnings, discouraging companies with export potential from fully reporting their earnings.

The regulatory regime that Russia had inherited from the Soviet Union was keeping the economy stagnant, and reinforced the predominance of the existing Soviet-era industrial and agricultural enterprises.[22] Dismantling this supporting structure of regulations, which inhibited existing companies and limited the entry of new firms in established markets, was an important first step in dismantling the Soviet enterprise network.

Freedom to Fail

Implicit in a functioning market economy is the ever-present possibility of failure: the obverse of reward is risk. In the Soviet system, however, failure was impossible because state-owned companies were not allowed to go bankrupt. A never-ending stream of subsidies ensured that no matter how poorly a company performed, or how useless were its manufactures or services, operations would continue.

As newly-privatized firms were exposed for the first time to the semblance of market conditions that was emerging in Russia in 1992, many began to realize that their business models, their method of operations, or their products or services were wholly unsuited to the needs of their customers. In a market economy, unsatisfied customers mean insufficient revenues—and firms that do not adjust to meet customer demands quickly become unable to pay their suppliers and workers. As a result, they go bankrupt.

Bankruptcy in this sense does not mean that the firms, their assets, their employees, or their products would disappear. Instead, new management would be installed and the firm's operations could continue, or the company's assets would be sold and deployed for more productive purposes.[23]

In 1992, Russia was plagued with hundreds of companies designed to function in a Soviet planned economy, and poorly equipped to compete in a free enterprise system. Even when reincarnated as newly-privatized companies, many continued to receive government subsidies to keep their money-losing operations afloat.

So long as it failed to give such firms the "freedom to fail," the Russian government would hurt the economy, and itself. The economy was hurt because resources were consumed inefficiently, taxes were kept high in order to pay the subsidies, and competition was stifled. The government was hurt because low sales and no profit left little to tax.

For all of these reasons, Yeltsin signed a decree on bankruptcy on June 14, 1992. But the declaration had little impact. First, it applied only to state-owned enterprises; bankruptcy of private and newly-privatized enterprises was not addressed.[24] Second, it *prevented* enterprises from being shut down, and prevented large numbers of workers from being dismissed.[25] Indeed, when the decree was superceded by bankruptcy legislation in November 1992, it had not yet been used to shut down a single firm.[26]

Nor did the 1992 bankruptcy law have more than limited impact. Though the law established conditions for both voluntary and mandatory bankruptcy proceedings, and directed the Russian government to establish procedures to liquidate bankrupt enterprises, it was largely aimed at preserving insolvent enterprises rather than eliminating them. Thus, one government official argued that "the first task" of the new bankruptcy law "is to help an enterprise survive."[27]

As of 1992, the lack of a workable bankruptcy procedure denied Russians the freedom to fail, assuring that a large share of Russia's productive potential would not be realized, and therefore also denying Russians the freedom to succeed.

Reducing the Tax Burden

Russia inherited Soviet tax laws that imposed a crushing burden on individuals and firms trying to generate wealth. So-called "windfall profit" taxes on enterprises reached as high as 90%, almost entirely negating the incentives to build profit-making businesses.

For individuals, Soviet personal income taxes were set at 13%, although the hard-pressed citizenry routinely ignored the requirement with no consequences. In 1990, in an effort to raise revenue, the Soviet Union raised the top income tax rate from 13% to 60% and imposed a new 5% sales surtax.

On top of these taxes, the Soviet Union imposed an additional tax on wages intended to dissuade employers from raising workers' pay. The Communist central government feared that higher wages would fuel inflation, because there were so few consumer goods available.

This high tax-rate regime left the system of government finance Russia would inherit from the Soviet Union in shambles. Tax evasion was rampant. International lenders—seeing no end in sight to the country's economic woes—were reluctant to make new loans.

Even more destructively, as Russia took more authority from the Soviet government in December 1991, the Russian Supreme Soviet imposed a 28% value added tax on top of the taxes already in place—which not surprisingly failed to increase government revenue.

Likewise, the Soviet bureaucracy of overlapping and multiple tax authorities, which provoked widespread tax evasion, continued in independent Russia.

Both the Soviet and Russian attempts to raise tax revenue by squeezing the turnip did not and would not work. To the contrary, lower tax rates were necessary to improve business conditions, reduce barriers to entry for entrepreneurs, increase competition, and generate more business earnings that could be subject to tax. Likewise, tax simplification was necessary to discourage tax evasion.

Lowering the tax rate and simplifying the tax code would demonstrate that the new Russian government was not bent on redistributing income, as was the Soviet Union, but rather was serious about discarding the Soviet system in favor of a market economy.

Prescribing the Rules of the Road

Because private economic activity had been illegal in the Soviet Union, there were few norms to guide private commercial transactions. Therefore, the challenge faced by Russia's central and regional governments was to promulgate a basic set of rules that could be relied upon by any Russian citizen (or foreigner, for that matter) who wished to buy or sell something.

While a system of clear, straightforward rules for the conduct of private business was unknown in the post-Communist Russia of 1992, the free world had long since produced such rules.

The operation of commercial codes in the United States is nearly invisible, but they are an essential part of a market economy. Clear, understandable, and well-settled rules for such everyday events as sales and leases of private property, business credit, bulk transfers, warehouse receipts, bills of lading, and investment securities are the infrastructure of the free enterprise system.

Today, neither Congress nor the legislature of any state is much concerned with the pressing issues of 19th century commercial law that gave rise to these codes. But that is not because these issues have been overtaken by modern events; to the contrary, the old rules remain on the books, in largely the same forms in which they first passed into the legal mainstream. They work so well that we have mostly forgotten them. They are now so well-established that a man or woman of commerce need give no more thought to such a question as "at what point during shipment does title pass?" than to breathing or walking.

The history of the United States' adoption of its various state commercial codes also holds lessons for Russia. The United States' experience was strongly influenced by our federal system, where both the federal government and the individual states have the power to pass laws (and where commercial arrangements are largely governed by state law).

In the 19th century, as the demands of interstate business and individual movement throughout the country accelerated, a unique solution to the problem of developing a nationwide commercial legal infrastructure was achieved outside of government.

Neither the legislature of any state, nor the Congress, but rather private individuals comprised a non-government body known as the National Conference of Commissioners on Uniform State Laws. Formed in 1892 for promoting "uniformity in state laws on all subjects where uniformity is deemed desirable and practicable," the Conference has since proposed more than 100 laws that have been adopted by at least one state.

The greatest success of the "uniform law" approach in the United States has been in the field of commercial and business law. The Commission's first product, the Uniform Negotiable Instruments Law, was at one time in effect in all the states. Using this and the Uniform Sales Act (also widely adopted) as a basis, the Conference (working together with another private body, the American Law Institute) eventually produced the Uniform Commercial Code. The

Uniform Commercial Code is now in effect in some version in nearly all U.S. jurisdictions.

The fundamental principle of the Uniform Commercial Code is the empowerment of individuals to reach agreements among themselves, without need of outside agencies of the state. Yet its greatest importance lies in the specification of what terms apply if the parties to a transaction *don't* mention something.

In the Russia of 1992, the lack of such clear rules meant that a butcher in Moscow could not make a contract with a supplier in Sergeiv Posad, an entrepreneur in Smolensk could not import fabric from overseas, and a builder in Chelyabinsk could not obtain lumber from a mill in Novosibirsk without incurring needless financial risk.

The overriding need for such rules in the Russia of 1992 was to provide certainty and predictability to economic transactions—a sharp contrast to the arbitrary dictates that had characterized the Soviet command economy. Particularly because of its lack of a tradition of private commercial activity, the enactment of a commercial code was a vital precondition for Russia's transition to a functioning market.

Welcoming Foreign Investment

Eliminating Soviet-era barriers to foreign investment in Russia was yet another basic step needed to construct a free enterprise system.

The climate for foreign investment that Russia inherited from the Soviet Union was a fundamentally inhospitable one. Not only were foreign investors deterred by the lack of market economy essentials—enforceable private contracts, private property rights, an established commercial code, competitive private banking, and a benign tax and regulatory climate—but also foreign investors faced unique obstacles that rendered any significant commitment to the Russian economy unthinkable.

The laws limiting expatriation of earnings were a unique burden on foreign firms seeking to invest in Russia. Capital controls limited a foreign firm's ability to return earnings from Russia to their stockholders. Further, government regulations discriminated against what activities foreign firms could engage in, creating uneven competition between foreign and domestic participants in the Russian market.

The Russian tax structure of 1992 likewise discriminated against foreign investment and trade. Even today, the average import tariff stands at 13%, the value-added tax on most imports is 20%, and the excise tax on most imported luxury goods ranges from 20% to as high as 570%. On top of that, Russia compounds various taxes when it assesses import levies. Combined with non-tariff barriers such as import licensing and customs processing fees, these taxes make the Russian market especially unattractive to foreign investors.[28] By keeping international trade out of Russia, these Soviet-era regulations reinforced the economic arrangements existing at the collapse of the Soviet Union. Instead of promoting competition that could serve as a model and a spur to Russian entrepreneurs, Russian law served to insulate the economy from these regenerating forces.

Tearing down these barriers to foreign investment was thus another key task facing the new Russia of 1992.

Creating a Market

The opportunities that awaited Russia in 1992 were exhilarating, but dismantling the Soviet system of government controls and erecting in its place a free market economy based on private decision making and risk-taking was a task of monumental proportions.

Yet the means to achieve the creation of a free market economy were abundantly clear: the government's job was to get out of the way of the economy, and facilitate private actors through the establishment of enforceable private contract rights, private property rights, laws permitting private commercial banking, commercial bankruptcy laws, a commercial code, a much-moderated tax burden, and the repeal of Soviet-era regulations that inhibited both domestic and foreign investment and trade.

These fundamentals of a free enterprise system needed to be implemented quickly, or else "privatization" would be a sham: "privatizing" assets into a non-market economy would represent merely the continuation of the Soviet system, with the difference that the financial benefits would now accrue to a few private individuals. It would lead to the development of a kleptocracy masquerading as a free market economy.

What was needed was legality—the certainty that private property rights will be protected—and the effective competition that this would inevitably produce.