Economic Reform and Private Sector Development in Russia and Mexico

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In 1987 two nations of critical importance to the United States, Russia and Mexico, embarked on the path of ambitious economic reform. Though marked by different historical, cultural and political legacies, both nations were impelled to act by global political and economic movements that have placed market mechanisms at the center of an increasingly integrated and competitive international economy. In this emerging order efficiency, productivity, and private investment are increasingly recognized as effective—and therefore preferred—determinants of national progress and economic development. In contrast, the icons of the communist and socialist state systems—central planning, state industries, autarchic economic structures and massive administrative bureaucracies—have come to be perceived as impediments to growth and national economic security.

Responding to this challenge, the policies promoted by Russia and Mexico both seek efficient, market-based systems that provide improved social welfare and integration with the world economy. To achieve this, they have adopted measures that are now the standard arsenal of economic reform regimes worldwide, such as privatization, the decollectivization of agriculture, and the lowering of domestic barriers to trade and foreign investment. The results of their efforts, however, differ. While comparisons between nations with different historical antecedents must be approached with caution, a number of critical policy challenges are shared by economic reform programs worldwide. Even where the nature of the steps taken by reform governments are similar (such as price liberalization and the sale of state enterprises) factors such as the pace and sequencing of reforms

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and the enlisting of public support can radically affect the outcome. Due largely to differences in how reform has been managed, Russia and Mexico find themselves on the threshold of different economic futures: Mexico showing considerable promise and Russia facing continued peril and long-term uncertainty. A comparison of the choices taken in Russia and Mexico indicates a number of the key requirements for the successful reform of centralized economies.

Russia—Reforming the State

Economic reform in the USSR was commenced in haphazard fashion under Mikhail Gorbachev, who deserves due credit for initiating the transition to a market economy. Financial reform was begun with the authorization of private and cooperative commercial banks, and incipient domestic securities and commodities exchanges. Industrial managers were given new authority and farmers were encouraged to lease land for production outside the system of state and collective farms. In foreign commerce, businesses were permitted to trade directly, ending the state's historic monopoly. Modest steps were also taken to dilute the state's exclusive ownership of property. The effectiveness of these steps was seriously compromised, however, by Gorbachev's equivocation regarding the pace and ultimate objectives of reform. Despite pledges to "radicalize economic reform," scant progress was made toward the privatization of state industries, and throughout Gorbachev's tenure production remained closely tied to central plans, leaving little real scope for market forces to take root. When confronted with the political pressures that accompany truly radical reform, Gorbachev hesitated. Numerous economic plans were considered, only to be dropped. Most critically, he stopped short of an explicit recognition of private property rights.

The demise of the Soviet Union in the fall of 1991 gave Boris Yeltsin and the Russian Federation new latitude to pursue truly far-reaching reform. Compared to Gorbachev, Yeltsin moved forcefully. Leaders committed to deep reform, such as Yegor Gaidar, Boris Fedorov, and Anatoly Chubais were appointed to the government. Prices were freed and sustained attempts made to reduce government spending, restrain growth in the money supply, and stabilize the ruble. Political resistance in the parliament and conflict over spending with the Central Bank undermined the effectiveness of these measures, and the lack of clear direction on the government's part continues to hamper reform. There is little doubt, however, of Russian government's commitment to major systemic change.

Agricultural and Industrial Privatization

In December 1991, Yeltsin launched land reforms designed to give farmers the right to rent, mortgage or exchange land; state and collective farm workers were given the right to land ownership. Since then over 22 million acres of land have been distributed free, including 13.5 million to small farmers. Because of parliamentary resistance, however, this policy was based only on decrees and was not based on a clear constitutional right to own, buy or sell land. As a result, the overwhelming share of agricultural land remains concentrated in state and collective farms, and limits on property transfer through sale or inheritance (resale is barred for at least five years) have forestalled a true free market for land. While many state farms have nominally re-registered as collectives and the number of independent farms has increased, Russian agriculture remains heavily dependent on state subsidies and distribution. In contrast, the recently granted right of individual Russians to own up to 1/4 acre and to buy and sell apartments has stimulated a growing market in residential property and a related construction boom. As a result, the supply of homes for sale around Moscow has tripled and the number of lots available has risen from zero to the thousands. A similar, if less dramatic, trend is underway in other Russian cities (Bohlen 1993).

More impressive progress is being made in the privatization of business and industrial enterprises. This has taken place through a variety of vehicles that include direct sales to employees, and sales to a combination of employees and outside investors through auctions and commercial tenders. At least 29 percent of each enterprise's stock must be sold at public auction. Most industries, however, remain in the hands of the existing workers and management, and the government will continue to maintain a large stake in many enterprises for a transitional period. Auctions of small and medium enterprises in services, trade, industry and transportation began in April 1992. By June 1993 more than 60,000 of Russia's 200,000 state-owned enterprises, mostly small businesses, had been sold, including half of all retail shops, restaurants and service establishments. The second phase of privatization involved larger industries; during 1993 over 8,000 middle-sized enterprises were sold. By early 1994, over 20 percent of all workers and 40 percent of workers in manufacturing were employed in privatized companies.

1993 saw the implementation of Yeltsin's program to divest large-scale industry through the redemption of 144 million vouchers issued to Russian citizens. Through that process most large enterprises have been converted to joint stock companies, as a precursor to the sale of shares. Voucher auctions for the sale of 7,500 enterprises employing

8 million people were completed during the first year of the program (Privalov and Kalinichenko 1994). The voucher phase of privatization was completed in July 1994 (future privatizations will require cash bids), with mixed but generally positive results. By June 30, 1994, 70 percent of all industrial enterprises in Russia were privatized.

Inflation ravaged the initial value of vouchers, while speculation, fraud, and lack of hard information on the companies being privatized also undermined their value. Nevertheless, over 14,000 large and medium enterprises have been put in private hands, 1 million new small businesses are operating, and at least 40 million Russians now own shares. Though failures will inevitably occur and significant structural problems remain, the voucher system has given Russians a direct stake in reform and will help to provide an element of financial and managerial accountability that has heretofore been lacking. It will also stimulate Russia's fledgling stock exchanges, which have struggled with illiquidity and a dearth of tradeable assets (Tanayev 1992).

Although the private and cooperative sector's share of employment is rising, because of the way in which privatized assets have been distributed state industries still account for a preponderant share of production. Moreover, the continued concentration of ownership in the hands of existing management and workers threatens to perpetuate Russia's monopolistic industrial structure, continuing to distort price and production signals. Thus, when prices were freed in 1992, the concentration of production in the hands of monopoly producers produced major price surges. Despite the existence of a state committee on anti-monopoly policy and a law on competition and the restricting of monopoly activity on commodity markets, the committee lacks the political power to challenge Russia's entrenched economic and bureaucratic interests. To ensure price competition, privatization must produce change not only in the titular ownership of industry, but a diversification of a nation's underlying economic structure.

Some of the most innovative steps have taken place at the municipal level, such as the World Bank-supported program in Nizhny Novgorod (Imse 1993). There, one device used to address this problem has been the forced sale of assets by companies undergoing privatization. This was done in the deregulation of trucking, where state trucking enterprises were each required to sell 20 percent of their fleet in open auction. This had the effect of producing a body of private truck owners capable of competing with established enterprises (Borodachev 1993). Nizhny Novgorod is also experimenting with agricultural reform through a pilot program in which collective farms are dismantled and occupants issued title certificates permitting them to acquire both land and equipment at auction.

Preference is given to current occupants, valuation of land and equipment and the allocation of the certificates is transparent, and decisions on how to organize production (either as individual farms or as partnerships) is left to the bidders. The Nizhny Novgorod experiment was authorized by Presidential decree in December 1992, as a laboratory of reform. Because of their ambitious pace, these measures were not immediately applied on a nationwide basis (though this is currently being considered). If this occurs, however, the process will be complex, as the Nizhny Novgorod program runs counter in spirit to other government programs that envisage large subsidies and a continued leading role for collectives and cooperative farms in the agricultural sector (Kotelnikova 1994).

Private Property and Constitutional Reform

After the parliamentary crisis of October 1993 another Yeltsin decree finally eliminated restrictions on the private ownership of land, authorizing the buying, selling and mortgaging of farm land and clearing the way for the breakup of large collective farms. More importantly, the new Constitution approved by national referendum in December 1993 specifically affirms the right to private property. Despite the mixed political signals sent by those elections (which also produced a large conservative-nationalist parliamentary bloc) the formal recognition of private property rights was a pivotal event whose implications for the development of a stable market economy are far reaching.

No clear rules yet exist to govern how property is bought and sold or how property rights are recorded and enforced, limiting the immediate impact of the constitutional change. Establishing a legal right to property does, however, play a more subtle role in supporting the development of the private sector, by providing a foundation for property rights that in recent years have been acquired on a de facto basis or under the authority of presidential decrees, but had never enjoyed clear legal status. A constitutional right to private property provides an important reassurance, in an environment of conflicting decrees and changing political alignments, of the irreversibility of reform and of the systemic legitimacy of private property transactions. This is an essential foundation for the private investment that business growth requires and for the functioning of a modern financial system in which assets can be securitized.

Complex, punitive taxes still impose a heavy burden on Russian entrepreneurs, undercutting the profit motive and the incentive for new business development. Beyond the problem of multiple overlapping taxes imposed by regions and municipalities, absolute levels of taxation approach confiscatory levels. In this respect, Russian policy is uncoordinated and internally conflicted, and runs counter to the larger objectives of privatization.

By maintaining high subsidies for state enterprises and by initially resisting the recognition of private property, Russia's Congress and Central Bank impeded the shift to a market economy, perpetuating both economic distortions and social pain. Despite this, privatization has remained a central element of the reform process, and despite persistent battles over economic policy has continued to advance at a relatively constant pace. Among its other beneficial effects, privatization is mitigating through new private sector employment much of the economic dislocation caused by market reforms. Significantly, following the resurgence of communist and bureaucratic forces in the government realignment of January 1994, the only major reformer to retain his cabinet post was Anatoly Chubais, the head of the privatization program.

Mexico—Freeing the Private Sector

Mexico presents a sharply contrasting picture. Beginning under President Miguel de la Madrid (1982–88) and with accelerating force under President Carlos Salinas de Gortari, Mexico has aggressively implemented privatization as the keystone to its market reforms.

Fiscal Discipline

Through fiscal discipline, inflation was reduced from 159 percent in 1987 to 8 percent in 1993, and the federal budget brought into balance. Public expenditures, less interest payments, have been reduced by a full 10 points of GDP and—through lower rates, a broadened base and strengthened enforcement—tax revenues have increased. Public sector debt dropped from 70 percent of GDP in 1987 to just 35 percent in 1993 (Sarmiento 1993).

Agricultural Reform and the Privatization of State Industry

Privatization was central to the Salinas strategy. The massive accumulation of assets and economic power in the hands of the Mexican government during the 1970s and 1980s had produced a large state sector whose continuing subsidization constituted a serious drain on the Mexican treasury. At the same time, private industry was protected from foreign competition by high tariff and non-tariff barriers. This produced widespread industrial inefficiency and a decline in both quality standards and competitiveness.

Mexico's privatization program began with the divestiture of small and medium-sized companies. This provided an initial base of experience.

Next, the government turned to companies that required internal reorganization before being offered to the public. In some cases companies were merged, closed outright, or sold at token prices. Only after such internal evaluations were large-scale public sales commenced, under the management of commercial banks acting as the government's agents.

Initially conceived as a vehicle to reduce pressure on the federal budget—by reducing subsidies and generating income from asset sales—privatization subsequently came to be seen as the key means to improve competition within the national economy. Of 1,155 state-owned companies in 1982, 934 have been divested, leaving only 221 in government hands. Major sales have included the two leading airlines (Aeromexico and Mexicana), the telephone company (Telmex), steel, insurance, hotels, mines, shipbuilding, gas stations, movie studios, manufacturing, and the entire banking system. Workers at state enterprises have the option to participate in bids, leading to a substantial employee role in many privatized companies. The program is open to foreign investors, who have figured prominently in a number of major bids. Sales to date have netted the government $20.9 billion.

In a variation of privatization, Mexico has also become a world leader in the private development of public infrastructure. Since 1989 thirty-two build-operate-transfer projects have been launched, with 28 more on the drawing boards, in areas such as highways, ports, power generation, airports and water projects. In late 1993 Mexico ranked sixth in the world in the construction of toll roads through private resources, with concessions granted for projects covering 2,400 miles of roadway (Corona 1993). Legislation was also enacted in the summer of 1993 authorizing the private management of ports. This option is effectively substituting private resources where public funds are unavailable, accelerating the development of infrastructure needed to sustain broad-based economic growth.

In another move that challenged entrenched constituencies, Salinas in late 1991 began the reform of Mexico's system of 28,000 "ejidos", or communal farms. Dating to the Mexican Revolution of 1910 and occupying half of Mexico's arable land, ejidos have long suffered from a lack of credit, shrinking plot size and low productivity. Under Salinas' reforms, communal farmers are now able to buy, sell and rent farm land, and ejidos have the right to sell land to both domestic and foreign investors.

Opening Markets to Investment and Foreign Competition

The Mexican government is seeking to improve national welfare by building an economic base that is competitive at the global level.

Opening Mexico's markets to foreign competition has been a key part of that process. Since 1982, when virtually all imports were subject to non-tariff barriers, import licensing has been eliminated and 80 percent of imports by value are free of quantitative restrictions. Tariffs have been reduced to a maximum of 20 percent, with a weighted average of 10 percent. While exports have been encouraged, most government export supports and subsidies have been eliminated.

To generate growth and service foreign debt, the government has aggressively courted foreign investment. Regulations were enacted in 1989 permitting 100 percent foreign ownership in most sectors, with automatic approval where investment is under $100 million. The number of industries limited to majority ownership by Mexican nationals has been reduced from 600 to 60. In 1994 Mexico's foreign investment law was formally revised to reflect these policies, reinforcing the stability of Mexico's investment climate. As a result of these measures, Mexico has attracted $33 billion in foreign capital since 1988, including $16 billion in foreign direct investment.

The Salinas administration's reforms have not been without cost, and their implementation has been less than perfect. A prolonged policy of tight credit (designed in part to attract continued foreign investment flows), when combined with new competition from imports, has bankrupted many small businesses and severely strained others. Much of the investment that Mexico has received is short-term and therefore vulnerable to withdrawal. While these inflows have financed Mexico's current account deficit they have also supported an overvalued currency, creating a potential source of instability. Financial problems have arisen in the toll road program. Nor are monopolies and favoritism a thing of the past. Unevenness in the distribution of the benefits of reform between wealthy and poor Mexicans and between Mexico's different regions could pose long-term problems if broad-based economic improvement falters. Nevertheless, the policy changes instituted since 1988 have on balance produced a broad-based rehabilitation of the Mexican economy, improving the quality and availability of goods and placing it on a competitive footing internationally. Most importantly, by fundamentally altering Mexico's economic structure the foundation for long-term growth has been laid, and the Mexican private sector has been given new freedom to lead the economy.

A Comparative Evaluation of Russian and Mexican Reform

Economic reform in Russia and Mexico is an effort to adjust—or in Russia's case to reverse—policies born of the two most epochal revolutionary movements of the twentieth century. Both Russia and Mexico entered the 1980s with a dominant political party, large bureaucracies, communally-based agricultural systems, large and inefficient parastatal sectors, government budgets burdened by high industrial subsidies, and inward-directed economic policies that restricted imports, limited competition, and discouraged foreign investment.

Because of the many historical and cultural differences between the two countries—the most important being Mexico's long and vibrant tradition of free enterprise—comparisons must be approached with caution. Nevertheless, a review of the strategies chosen by the Russian and Mexican governments reveals contrasting priorities that help to explain the relative success of the two reform programs.

Political Leadership

The success of Mexico's economic strategy has been supported by two critical elements. One is the boldness and comprehensiveness with which reform has been pursued. Salinas exerted strong personal and political leadership throughout the process, challenging even the most formidable political obstacles, interests or orthodoxies. Difficult political issues, such as reform of the ejidos or of the foreign investment law, were deferred but not avoided. In contrast to Salinas' boldness, the Soviet/Russian road to reform has been marked by uncertainty. Though begun at approximately the same time (1987), Gorbachev's approach was distinguished by a cautious incrementalism and a reluctance to fundamentally challenge existing economic structures; much of his term was spent attempting to improve or fine tune existing state mechanisms. As a result, the pain of transition was extended and the benefits of reform postponed, creating an economic limbo and breeding ground for political dissatisfaction. The foundation of a market economy—the development of a working private sector—was all but ignored until Yeltsin's presidency. This contrasts with Mexico's strategy, in which reform has focused on fostering an independent and competitive private sector.

Coherent government leadership in Russia has been in short supply. Where the Salinas government operated with a tight team of like-minded technocratic professionals, since January 1992 Russia has seen three prime ministers, four finance ministers, two central bank governors, two parliaments, two constitutions, and a stream of conflicting presidential decrees. The Russian public and business community, not to mention foreign businesses, can be forgiven if they are confused about the present or future direction of policy.

Procedural Fairness

Despite the social hardship produced by reform, the Mexican people have given a high measure of support to Salinas' programs. Although for many poorer Mexicans the standard of living has yet to improve, for many others the past six years have seen increased prosperity and a resumption in the real growth of personal income. What is politically critical in these circumstances is the public perception that change is required, that it is being managed equitably, and that measurable progress is being achieved. Because the Mexican government has largely met these criteria, hope and the belief in a better future have convinced the Mexican public to endure near-term hardship and have reinforced the political base for reform. As elevated expectatons of progress can be deflated by cyclical or other economic reversals, however, leadership, transparency and equity in the management of reform assume particular importance.

The critical importance of the political and social elements of reform has been acknowledged by Mexico's leadership. According to Pedro Aspe, "Confidence can rapidly disappear if the policies are not perceived as being consistent with the announced objectives . . . Government entities should be interested not only in bringing about better standards of living for the population, but also make them profound, on a day-in, day-out basis" (Aspe 1991: 23).

To maintain public confidence in privatization, procedural transparency is an absolute requirement. Any perception that the divesting of public assets will unfairly benefit special interests will undermine public acceptance of the burdens of reform. Although many of Mexico's privatized assets are owned by a relatively small elite, the policy continues to enjoy support because of the widely-shared view that the process has been fair and that its proceeds will benefit the nation (through new resources for social welfare and the retirement of public debt).

The lifting of price and foreign exchange controls and the removal of disciplines once imposed by the state's monopoly on power and resources have produced conditions of economic disorder that pose a direct threat to the Russian reform process. Support for reform is also being undermined by the widespread perception that the primary beneficiaries of reform are the old "nomenklatura" and criminal "mafia" who profit from illicit access to and manipulation of public resources. The Ministry of the Interior estimates that organized crime controls one-third of all turnover in goods and services; this directly affects the economy through increased prices, the cost of private security, and the discouragement of both domestic and foreign investment (Erlanger 1994). The popular view that, as in the former Soviet Union, privilege and connections permit a minority to benefit at public expense undermines support for legitimate entrepreneurship, and poses a direct challenge to the credibility and influence of reformers.

Prioritizing Reforms

The Salinas administration also sequenced its program to make the components of reform mutually reinforcing. For example, revenues from privatization, reduced federal spending, and a policy of tight credit served to reduce inflation and support the value of the peso, creating an attractive environment for foreign investment. These foreign investment flows, in turn, have largely offset the current account deficit caused by rapid trade liberalization. The resulting balancing act can pose severe problems of economic management. For example, prolonged high interest rates, while helping to attract investment, can also starve small and medium industry of the capital it needs to invest and innovate. Likewise, to manage current account imbalances in the longer term, foreign and domestic investment must be rapidly translated into gains in productivity and exports. Careful sequencing is essential, since the benefits of action in one area can be easily diluted or offset by ill-timed decisions in another.

The sequencing and coordination of reform measures has posed particularly severe problems in Russia. Gorbachev's foot dragging on privatization and his procrastination over the issue of private property delayed the development of a true private sector and cost Russia precious years in creating a working market system. When prices were liberalized in 1992, therefore, Russia's underlying industrial structure remained highly monopolistic and prices surged. While entrepreneurs and workers have been encouraged to acquire state assets, confiscatory tax rates have all but eliminated legal (as opposed to black market) profits and the incentive for new investment. Expansive fiscal and credit policies stimulated by high industrial and agricultural subsidies have produced high inflation, undermining the process of economic stabilization. Macroeconomic stability is vital to private sector development, particularly in economies undergoing major structural reform.

Open Markets and Competition

The key to Mexican reform policy is its objective to increase national economic efficiency by stimulating the private sector. This is being achieved by stimulating domestic competition and by exposing Mexico's economy to global market forces. Mexico's entry into GATT in 1986 was a cornerstone of that strategy. Its 1989 negotiation of a free trade agreement with Chile, a 1993 free trade agreement with Colombia and Venezuela, and its successful pursuit of a North American Free Trade Agreement with the United States and Canada also reflect this approach.

In this strategy, Mexico has largely dismantled the system of import barriers and subsidies that protected the private sector. Despite the attention given to NAFTA, much of Mexico's import liberalization has been unilateral. Exports are being encouraged not by export subsidies but through broader measures designed to stimulate confidence within the Mexican business community. Competitiveness is also being stimulated by the withdrawal of the state from management of all but the most "strategic" sectors (petroleum), by deregulation (trucking and tourism), and by a more receptive attitude toward foreign investment.

In other words, while the Mexican government has led the reform process, it has done so not by generating new administrative programs but by creating an economic and regulatory environment that supports self-sustaining private sector growth. As Finance Minister Pedro Aspe, a principal architect of Mexican reform, has observed, "A larger state is not necessarily a more capable state" (Aspe 1991: 23).

In Russia, privatization is taking place through both formal and informal processes. Only a fraction of the stock of privatized companies has been sold to the public; the balance (as much as 70 percent) remains in the hands of workers, existing management and the state. In this ownership structure the first priority of management is often to maintain its control position, while that of labor is to protect or increase wages; this does not necessarily lead to new investment or improved competitiveness. In many cases existing management has "privatized" unilaterally or has established parallel enterprises that have surreptitiously bled off state assets. In the context of privatization this equates to insider trading. Despite the questionable legitimacy of these processes, the result may be productive if it leads to a viable and independent private sector. Serious structural problems will persist, however, if the "new" enterprises are not exposed to a truly competitive environment or are sustained through protective import barriers and continued state subsidies.

At the international level, the Russian government shares with its Western counterparts an obvious vulnerability to lobbying by domestic industry for both subsidies and trade protection. Tariffs on a wide range of consumer imports were sharply increased during 1994. To the extent that imported goods are restricted from the Russian market, existing monopolies will be reinforced and competitive pressures that would in other circumstances stimulate improved quality and productivity will be suppressed.

Outlook

Challenges to Russian Reform

Because of the heavy legacy of central planning and the equivocal nature of reform under Gorbachev, Russia will continue to face serious hurdles in its effort to implement a working market economy. In an environment of political uncertainty and economic instability, the Russian government a must sustain the momentum of reform. Subsidies to industry must be withdrawn on a progressive but clear timetable, and politically effective regulatory mechanisms established to ensure fair trade, encourage price competition and discourage monopolies. Taxes must be made both more predictable and less burdensome to fledgling businesses. As a stimulus to competition, barriers to imports and foreign investment must also be reduced. In the process of converting state industries to private companies, new attention must be given to making management and directors more accountable by increasing the proportional authority of outside shareholders in privatized companies. Wherever possible, assets owned by privatizing companies should be partially dispersed so that new businesses can be created, competition encouraged, and monopolies diluted. In the agricultural sector, the Nizhny Novgorod model should be applied on a nationwide basis, and newly-confirmed constitutional land rights reinforced by a strengthened legal system for the registration and transfer of title.

Maintaining public support is also essential if long-term reform is to be sustained. As Vaclav Klaus, Prime Minister of the Czech Republic, has observed, "Systemic transformation is not an exercise in applied economics or in applied political science; it is a process which involves human beings" (Klaus 1993). It is critical therefore that the public component of reform be fully integrated into the government's reform strategy, and that public attitudes and concerns be addressed. The necessity of reform, together with its costs and objectives, must be communicated, and the government's vision clearly articulated.

One major hurdle facing reform is the fact that market economics and entrepreneurship are presently linked in Russian public perception with criminal activity, corruption and economic inequity. While this can partly be attributed to ingrained Soviet thinking, it frequently has a basis in fact. Crime in Russia has risen visibly, with corruption extending from organized criminal gangs to the police and government. This undermines the legitimacy of the reform process itself. As shown in Mexico, fairness and transparency influence public attitudes and the time and latitude that will be given the government to achieve its long-term goals. To achieve this, strengthening the rule of law is essential. Continued privatization and deregulation can also have an impact in this area, by shifting more of the economy into private hands and reducing the opportunities for corruption that are produced by the excessive concentration of economic power in official hands.

The success achieved by ultra-nationalist and communist forces in the elections of December 1993 was a reminder that the future of Russian reform is far from certain. Among the ideas proposed by Vladimir Zhirinovsky are the maintenance of subsidies for state industries, the retention of large industry in state hands (in effect limiting privatization to small and medium enterprises), and continued state ownership of land. These ideas are shared in less extreme form by communists and many industrial managers, who continue to demand large subsidies and would welcome a return to some form of central planning (Zamyatin 1994). Such a relapse would only, however, produce continued stagnation and even greater instability.

Seeds of Success

In the end, a break in the umbilical cord between industry and the government must take place if reform is to become irreversible and self-responsibility in the management of enterprises firmly established. To achieve this, and because of its multiplier effects throughout Russia's economic and political structure, privatization must remain the principal engine of reform.

The current Russian debate over economic reform divides into two major camps: economic liberals who stress the need to control inflation and foster the private sector, and economic traditionalists who emphasize the need to preserve Russia's historic industrial and scientific base through subsidies and other centrally directed measures. Despite debilitating swings in the value of the ruble and plummeting production statistics, other more positive signs suggest that a market system is actually taking root. Official production figures address the state sector but do not take account of the private sector, which accounts for a growing share of economic activity; this under-reported private sector activity partly explains why official unemployment estimates have not risen more rapidly. Reported declines in production, though real, are also measured against historical production figures that were inflated to meet central production quotas. Retail activity has been remarkably steady, suggesting again that official measurements of production under-report the effects of private economic activity.

Despite an array of problems, Russia's privatization can be judged a relative success. GUM, the once-shabby government department store, provides a good example of the benefits of both privatization and market opening. With over 18,000 shareholders, half of GUM's major co-owners are foreign investors. Since being privatized it has grown to become Russia's largest trading company and one of Russia's largest private enterprises. Profits grew eight fold in 1993 to R40 billion (Aspin 1994). Similar, if less visible, examples exist throughout

Russia, as new entrepreneurs have risen to the surface and economic experimentation has occurred.

The development of a viable and self-sustaining private sector is the indispensable foundation of any market economy. Mexico's experience strongly points to the efficacy of a private sector-centered reform strategy. Continued progress in private sector development also holds the key to Russia's efforts to establish a market economy and restore economic and political stability. Long-term stability with growth cannot be achieved through monetary tools alone; it will also depend on a functioning private sector that both generates and responds to market signals. Other elements of an overall reform package (monetary policy, taxation, deregulation, etc.) must be directed and sequenced with the primary objective of reinforcing private sector development. Thus, for example, controlling the fiscal deficit is essential to maintaining stable prices, interest rates and exchange rates—all preconditions for a healthy private sector. The reduction of subsidies, taxes, monetary growth and government deficits is also necessary to control inflation and create an environment that is favorable to business formation and long-term investment. Consistent, predictable, and mutually reinforcing macroeconomic policies are essential.

Privatization can help to relieve pressure on government budgets, but in the absence of competition it's ability to produce a healthy economy is limited. Economic reform must therefore focus not only on the transfer of assets from government hands, but on the dilution of monopolies and the exposure of privatized companies to both domestic and international competition.

Economic reform is also linked to political reform. While not a guarantee of democracy, market economies provide an environment that is conducive to it. Experience in Asia (Korea, Taiwan, Singapore, China) and in South America (Mexico, Chile, Peru) suggests that full democracy is not a prerequisite for the development of vibrant market systems. However, economic freedom leads to pressure for new political options and personal rights. This occurs through education, increased disposable income, travel, access to information, and the simple fact that life's more basic requirements (food, housing and health) have been met. By fostering an expanded middle class, economic reform strengthens the constituency for political as well as economic liberalization.

The priorities for political and economic reform vary from country to country, depending on historical and cultural circumstances. Nevertheless, as experience in Mexico and Russia demonstrates, concentration on institutional and administrative reform is a less effective vehicle for long-term economic reform than a well-conceived economic program designed to engender an independent, broad-based and self-sustaining private sector.

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