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Russia’s Economic Liberalisation: Lessons for Libya?

Anders Åslund

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Russia’s Economic Liberalisation: Lessons for Libya?[1]

Anders Åslund[2]

Executive Summary

Libya may be able to draw some lessons from Russia’s experiences in its early transition, from both what worked and what did not. Since Libya’s macroeconomic problems are far less serious than Russia’s were in 1991, Libya’s transition should be much easier. Nevertheless, Russia’s experience could be instructive.

Russia suffered from extraordinary macroeconomic instability, which Libya should avoid. It took years for Russia to establish macroeconomic stability. It only occurred after it had given the Ministry of Finance control of all public revenue and expenditure and compelled it to check the budget deficit, after the central bank had grown strong and independent, and a market-oriented exchange rate policy had been established. Russia solved its fiscal problems by adopting a simple tax system with few taxes with broad tax bases and relatively low tax rates. The IMF was crucial in Russia’s resolution of its macroeconomic problems.

The greatest opportunities and the worst threats lay in the oil sector. Oil dominates both the Russian and Libyan economies. The Russian lesson is that domestic oil prices must be liberalised early on to allow prices to be similar at home and abroad. As that was not the case in Russia, some people bought oil cheaply at low domestic state-controlled prices and sold it abroad at high international market prices. Those traders later bought the Russian state.

Russia broke up the national oil company early on and privatised the resulting companies. Economically, this was a success, but the new owners of the oil companies were never accepted by the Russian people or the government, which caused legal, economic and political havoc and which led to their re-nationalisation. With hindsight, it would probably have been preferable to go slow on the privatisation of oil companies while trying to improve their corporate governance to check their performance and political power.

The greatest success of the Russian reforms was the early formation of a fully-fledged market economy by liberalising prices, markets and enterprise formation. The most successful part of the privatisation was the sale of small and medium-sized state-owned enterprises by regional and local authorities. It was less important how they were sold than that the sales took place.

During the first decade of transition the overwhelming share of all investments was financed from retained profits. No source of enterprise, neither domestic banks nor foreign sources, made a difference. Foreign international financial institutions can basically do two things, offer advice and offer financing. The IMF can provide the government with the necessary financing for macroeconomic stability and sound macroeconomic policy and the European Bank for Reconstruction and Development (EBRD) can assist with some enterprise financing and good corporate governance of state companies.

A crucial Russian failure was not building an independent judiciary, which would have been vital for the establishment of real property rights. It should have been a priority.

1 This research paper is part of a series of publications prepared in the framework of the ‘Dialogue Platform for Peace and Stability in Libya.’ The project aims to establish a platform for dialogue and exchange between Libya’s main political forces, Libyan and international researchers and key actors in the international community on key policy ideas for Libya’s future.

2 Dr. Anders Åslund is a senior fellow at the Atlantic Council in Washington, D.C. and an Adjunct Professor at Georgetown University. He worked as an economic advisor to the Russian government from 1991 to 1994. He has written four books about Russia’s economic development from 1985. The author thanks Luigi Narbone, Virginie Collombier and Maya Tamimova for their helpful comments. He takes sole responsibility for any errors.

Introduction: The Relevance of Russia's Experience to Libya

Russia when it abandoned communism in 1991 and Libya today have many similarities that may make it worthwhile for Libyans to look at Russia and learn from both its problems and achievements.[3] However, there are also important differences.

Key similarities between Russia then and Libya now are that both countries were centralised socialist command economies and that oil and gas were their main sources of export and tax revenue. In both countries, the state owned the overwhelming share of the economy, especially large companies and the raw-material industry. Prices were predominantly but not completely controlled by the government. On paper, both countries had extensive social welfare states. The similarities can be summarised in a few words: state control and oil dominance. The main difference is that Russia started with a catastrophic macroeconomic crisis.

Politically, the situations were quite different. Russia did not have serious secession problems, apart from Chechnya, a small territory in the south, while the establishment of a central government is a major concern in Libya. In Russia, radical market economists stood against old-style state communists who wanted to restore the old system.[4] Initially, there was no middle ground, neither economically nor politically, whereas ideological differences do not appear so polarised in Libya. Russia had an all-dominant political leader in President Boris Yeltsin. In November 1991, he appointed an outstanding young economist, Yegor Gaidar, as his chief economist. He later rose to be acting prime minister. Gaidar, who published many books, provided the economic model for the Yeltsin government.[5]

The Yeltsin government aspired to create a normal market economy with dominant private ownership. Its first aim was to stop hyperinflation to stabilise prices and the exchange rate, which was very difficult because of a lack of relevant economic knowledge and an absence of strong economic institutions. A second aim was to liberalise the market, both prices and trade, to end shortages, which was much easier. The third goal was to privatise the dominant state enterprises as fast as possible to secure the market economy.[6] The Gaidar government, which was dominated by economists, had no capacity to deal with the social safety net or the building of a sound judiciary. Initially, it received no Western assistance because the West was hesitant in helping Russia to recover.

The reason for the Russian government's radical market economy choice was that Russia's economic situation was truly catastrophic. It required radical action in one direction or another. Russia was in the midst of hyperinflation, which brought about complete demoralisation. Nothing good could happen until it was stopped. At the same time, the Soviet Union suffered from nearly complete shortages during its last year. The shops were literally empty because the prices of essential goods were controlled at a low level while supplies were absent. The government had lost control of revenue collection, public expenditure and the issuance of money. Therefore, both macroeconomic stabilisation and price and market liberalisation were vital.

The third priority was privatisation. This could not be done fast. Here, numerous ideas competed. The collapsing state was seen as a nobody. One idea was to give enterprises real 'masters' so that somebody took responsibility for them. Another idea was that the state enterprises must not be given away to the industrial ministers or the state enterprise managers but to their workers or the citizens and a capital market should be initiated.

An important complication of the Russian reforms in the early 1990s that has not been well understood is that government power had collapsed, which had two important effects. On the one hand,

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3 The author is specialised in the Russian economy. The main source of reference for this report is Åslund, Anders (1995), *How Russia Became a Market Economy*. Washington: Brookings Institution.

4 Åslund (1995), pp. 63-70, 73-86.

5 Yegor Gaidar described his reform policies in his memoires, Gaidar, Yegor T (1999), *Days of Defeat and Victory*. Seattle, WA: University of Washington Press.

6 President Boris Yeltsin presented his programme to the parliament in a speech largely written by Gaidar. Yeltsin, Boris N (1991), B.N. Yeltsin's Speech. *Sovetskaya Rossiya*, October 29.

the government had great freedom to make strategic decisions, such as liberalising prices and trade. On the other, it had very limited capacity and could not administer complex reforms, such as medical, pension and education reforms. It was best for the government to focus on a few big decisions.

Some aspects of the Russian post-communist economic experience are relevant to Libya, but not all because of differences in preconditions. This paper focuses on the main elements in the early Russian transition and draws conclusions on each of them for Russia while also suggesting what might be of relevance to Libya and offering tentative recommendations.

The Russian Transition Period: Why the Liberal Economic Model Was Chosen

Russia's economic transition is often described as 'shock therapy'[7] but in reality the reforms were quite protracted, lasting from 1986 until 2002.[8] They were undertaken in steps but they did not follow any economic logic. Instead, they were driven by specific interest groups. The most important interest group was state enterprise managers. From 1987, reformist intellectuals started to play an outsized role. After the republican parliamentary elections in early 1989, the republican parliaments seized the initiative. These three groupings had little in common apart from a strong urge to change, and the contradictions between their ideas drove the Russian reforms both before and after the collapse of the Soviet Union.

The first important reform occurred in 1986, when big state companies were permitted to conduct their own foreign trade. The liberalisation of prices and exchange rates was very gradual, with several very different exchange rates. A 1988 law on cooperatives allowed private enterprises, paradoxically including completely unregulated private banks. In 1988, state enterprise managers were allowed to run their state companies without real state control, which soon led to many tacitly privatising the companies they managed.

In 1990, the union republics took over the reform initiative. They endeavoured to control both fiscal and monetary policy. As a result, centralised tax collection collapsed and the union republics and the central government competed to raise wages and issue more social benefits. In 1990 the fifteen Soviet republics established their own central banks, but the Soviet Central Bank remained. These sixteen central banks started competing to issue unlimited rouble credits, which resulted in hyperinflation in all the former Soviet republics in 1992. The Soviet Union collapsed on 25 December 1991.[9]

7 The main advocate of radical market reform was Professor Jeffrey Sachs, "What Is to Be Done?" *Economist*, January 13, 1990.

8 The author has discussed the whole reform process in Åslund, Anders (2007), Russia's Capitalist Revolution: *Why Market Reform Succeeded and Democracy Failed*, Washington: Peterson Institute for International Economics.

9 Åslund (1995); Granville, Brigitte (1995), So Farewell Then Rouble Zone. In *Russian Economic Reform at Risk*, ed. Anders Åslund. New York: St. Martin's Press.

Key Liberalisation Policies in Russia

The first section of this paper discusses macroeconomic issues. The second section considers the liberalisation of prices, markets and entrepreneurship. The third section deals with privatisation and the fourth discusses the particularities of oil. The fifth section focuses on property rights and judicial matters. The report ends with conclusions from Russia of possible relevance to Libya.

Macroeconomic Stabilisation

When the Soviet Union collapsed, it faced a horrendous macroeconomic crisis that was far worse than what Libya is likely to experience. No element of the macroeconomic regime was functioning, neither monetary policy, fiscal policy, taxation nor banking.

Hyperinflation was the dominant economic problem in 1991-92. As the Soviet Union fell apart all fifteen of the newly independent republics were ripe for hyperinflation, at least 50 percent a month. In world history, only 56 cases of hyperinflation have been recorded. Half of them occurred during the collapse of communism, mainly in the former Soviet Union, but also in former Yugoslavia and in eastern Europe (Poland and Bulgaria).10 The causes of hyperinflation were manifold: excessive issuance of money, collapsing tax revenue, skyrocketing public expenditure, the maintenance of too high official exchange rates, irresponsible banks, excessive public and foreign indebtedness, a lack of understanding of macroeconomic theory and an absence of international expertise and financing.

Worst of all was the absence of central control over the issuance of money. From 1990 to 1993, the fifteen ex-Soviet republics and the Soviet Central Bank were engaged in competition to issue rouble credits. No price stability was possible until the rouble zone had been broken up and each republic had established its own monopoly on its national currency, which largely occurred in the summer of 1993. The most important step toward monetary stabilisation was that the Central Bank of Russia cut off its crediting to the other former Soviet republics.

The next step was to set credit limits for Russia itself, which was a political struggle between the old-style central bank and the more reformist Russian government. In October 1994, the central bank appeared to have made a catastrophic mistake excessively issuing money, which led to a precipitous fall in the rouble exchange rate. The broad Russian establishment concluded that the central bank governor had spearheaded a harmful manipulation by a small group of insiders. As a consequence, President Yeltsin sacked the governor. He then initiated a strict monetary policy, resulting in Russia's central bank gaining strength in late 1994. Only much later did the central bank gain independence, but from this time it pursued a strict monetary policy with high interest rates.[11]

At the end of the Soviet Union, Russia ran out of international reserves and the Soviet foreign debt exceeded Russian GDP and could no longer be served. The exchange rate plummeted so that the average Russian monthly salary was a paltry $6 in December 1991 at the free exchange rate, completely humiliating the Russian middle class.[12]

The exchange rates had to be unified and adjusted to the market. The unification was critical and essentially done by 1993, while the market adjustment of the exchange rate could be done in many ways. After many trials with more or less fixed exchange rates, in 2014 Russia settled for a floating exchange rate that adjusts to the global oil price, but international practice shows that no option is definitely the right one.

Fiscal policy was also a complete mess from late 1990. Here the main problem was that the union republics and the central government began competing both in cutting taxes and in raising public wages and social benefits. As a result, centralised Soviet tax collection and control of public expenditure ceased in late 1990. There is no definitive size of the Soviet Union's budget deficit in 1991 but it was in the

10 Hanke, Steven H. and Nicholas Krus (2012), World Hyperinflations, Working Paper, Cato Institute.

11 Ibid, Åslund (1995).

12 Ibid, Åslund (2007), 72.

order of a third of GDP, none of which was financed.[13] It took years for Russia to form a strong ministry of finance and tax service that achieved the monopoly of both taxes and public expenditure. Arguably, this did not occur until after the financial crash in August 1998.

It took much longer to put fiscal policy in order. The turning point was the August 1998 financial crash, when Russia defaulted on its domestic debt, devalued the rouble by three-quarters and froze banking for three months. Paradoxically, the combination of Russia's default on its domestic debt and the freezing of bank payments for three months led to a catharsis in the Russian macroeconomy. Russia could no longer borrow cheaply; bankers and other operators could no longer make money through sheer speculation; and the state could no longer finance itself by issuing debt. It was compelled to eliminate a persistent budget deficit of 8-9 percent of GDP since international finance was no longer available.[14] The state had to cut its expenditure to what it could raise in taxes, and businessmen had to start producing. Both the state and businessmen acted accordingly.[15]

The Russian tax system was a dysfunctional maze. The main problems were that the rich did not pay taxes and that the tax system was far too complex for small and medium-sized entrepreneurs. Between 1997 and 2002, a radical tax reform was adopted. The main reform ideas were not very original but sensible: few taxes, broad tax bases and low tax rates. Russia did away with a maze of some 200 taxes and cut them to about a dozen key taxes. The main ones were oil and gas taxes, payroll tax and value-added tax. The two taxes that generated the most revenue were a value-added tax of 20 percent and a payroll tax of about 33 percent. Other important taxes were a personal income tax, which was cut from a progressive tax going up to 30 percent to a flat income tax of 13 percent, and a corporate profit tax that has varied but stays around 20 percent of net profit. After these come excise taxes on luxury products and import tariffs. In different forms, either as royalties or export taxes, oil and gas have consistently provided about half of Russia's state revenue.[16]

As if these problems did not suffice, Russia had a large, speculative banking sector. The 1988 law on cooperatives had not excluded banks, so when the Soviet Union ended Russia had 1,600 predominantly private banks based on this law. Since no bank law existed the private banks were completely unregulated, but they were not real banks. They received credits from the central bank, for which they paid nearly nothing thanks to the high inflation, and with these credits they bought commodities, primarily oil. These novel banks gave little or no credit to producing enterprises. When the Russian government succeeded in defeating inflation, interest rates caught up with inflation so that many of them collapsed. Neither the rise of these banks nor their collapse impacted the real economy much, although depositors suffered repeatedly. There was no plan or excuse for the creation of these destabilising speculative banks. They were merely an accident and they did no good to society, although certainly to their owners. As soon as inflation abated in 1994 the country saw repeated bank crashes, with the worst in 1998 when half of the remaining private banks (600) went under, including eight of the ten biggest oligarchic banks.[17] As a consequence, a gradual renationalisation of the banking sector ensued.

The role of international financial institutions, primarily the International Monetary Fund (IMF), was important. The IMF is the global organisation for macroeconomic stabilisation, which rarely happens without its contribution. It can offer advice on sound macroeconomic policy and provide governments with the necessary financing for macroeconomic stability. Unfortunately, the IMF played no role in the early part of Russia's transition, because Russia only became a member of it and the World Bank in May 1992. From 1994 to 1996 when the Russian government started becoming serious about macroeconomic stability, the IMF became a serious force in Russian macroeconomic policy providing substantial loans. However, in 1996-97 foreign portfolio investments were flooding Russia, primarily in government bonds but also in stocks. The IMF then lost its influence on foreign capital inflows. In October 1997 Russia faced the typical emerging market dilemma of a sudden stop as the stock market collapsed

13 EBRD (European Bank for Reconstruction and Development) (1994), *Transition Report 1994.* London: EBRD.

14 Owen, David and David O. Robinson, eds. (2003), *Russia Rebounds*. Washington: International Monetary Fund; Åslund, Anders (1998), Russia's Financial Crisis: Causes and Possible Remedies. *Post-Soviet Geography and Economics* 39, 6: 309-328.

15 Owen, David and David O. Robinson, eds. (2003), *Russia Rebounds*. Washington: International Monetary Fund.

16 Åslund (2007), 190-197.

17 Johnson, Juliet (2000), *A Fistful of Rubles: The Rise and Fall of the Russian Banking System*. Ithaca, NY: Cornell University Press.

and the bond market froze.[18] Russia lost out both when the IMF could not assist it early on and when it became sure of gaining foreign funding regardless of its public deficit. Paradoxically, the IMF advice had the greatest effect from late 1998, although the IMF could no longer provide Russia with any financing.

Lessons from Russia's macroeconomic stabilisation

1. Russia's initial monetary problem was the absence of a single currency and that the central bank did not control the issue of credit and currency, which led to uncontrolled excessive issuance of credits causing hyperinflation. Hopefully, this will not apply to Libya.

2. A strong, independent central bank is vital for the control of inflation in any country. This was the second step to macroeconomic stability in Russia.

3. Initially, the Russian ministry of finance was uniquely weak, as many other state institutions collected state revenue or expended state funds. The ministry of finance controlled neither public expenditure nor revenue. Only after the ministry of finance had grown strong enough to control both revenue and expenditure was fiscal control established. This is true of any country.

4. A simple tax system needed to be established with few taxes, broad tax bases and limited tax rates. A well-functioning tax system was adopted in 1997-2002.

5. The early Russian private banks were wild speculative operations destabilising the economy while generating little value for the national economy. In the 1990s, the Russian banking sector offered little credit to private manufacturing or services. More than 80 percent of all private investment was financed from retained profits.[19]

6. In Russia like all over the world, the IMF was vital for successful macroeconomic stabilisation. Its main aim is to make sure that a client has sufficient international currency reserves to maintain a reasonably stable exchange rate. The strengths of the IMF are that it is fast, competent in macroeconomics, focused on a few key issues and has large funds instantly available. Ironically, in Russia, the IMF's advice was most effective after the 1998 financial crash when it could no longer provide Russia with financial assistance, although its economic advice became rather more effective.[20]

The Liberalisation of Prices, Markets and Entrepreneurship

Arguably, the liberalisation of prices, markets and entrepreneurship was the greatest success of the Russian transition. The aims of the liberalisation were to establish free market prices of goods and services, to free the market for good and services, and to allow free private enterprise. By and large, these aims were achieved in no time. This was the real radical market reform.

At the end of the Soviet Union, the excessive expansion of the volume of money and the continued price controls for most key consumer goods, probably 90 percent, led to almost complete shortages of ordinary foods in Russian shops, while a marginal private market for very expensive goods persisted. On 2 January 1992 the new liberal Russian government that was formed in November 1991 had no real choice but to opt for near complete price deregulation.

With the exception of a few commodity prices, all prices were liberalised early on. This may sound cruel, but the Soviet reality was that most products were not available at any price for ordinary Soviet citizens-but only for those with privileged access. Therefore, the liberalisation of prices was quite acceptable and caused no public protests because it meant the end of nearly complete shortages. Similarly, Russians, together with Poles and Estonians, demanded the complete liberalisation of imports in the early transition because they wanted an end to shortages. Given the very low salaries at the free exchange rate,

18 Reinhart, Carmen and Guillermo Calvo (2000), "When Capital Inflows Come to a Sudden Stop: Consequences and Policy Options," MPRA Paper 6982, University Library of Munich.

19 EBRD (European Bank for Reconstruction and Development) (1999), *Transition Report 1999*. London: EBRD.

20 Owen, David and David O. Robinson, eds. (2003), *Russia Rebounds*. Washington: International Monetary Fund.

it took years for protectionist pressures to mount. Some problems arose with some monopolisation, as the market did not become saturated as fast as could have been possible, but they were of limited significance. Remarkably, after the market had been established no reversal occurred.

Establishing a market allowing goods and services to be exchanged at a price set by supply and demand seems to have been the easiest part of the transition. Unfortunately, the Anti-Monopoly Committee was ineffective, typically defending actual monopolies rather than promoting competition because it was not a very powerful agency, not daring to check the real monopolies. Instead, it controlled the prices of companies that were not monopolies. Only in 1997 did the Russian Anti-Monopoly Committee recognise Russia's main monopoly, Gazprom, as a monopoly. Instead, it raised bureaucratic hurdles for harmless medium-sized enterprises.[21]

The main obstacle to the liberalisation of trade and prices did not lie in imports but in exports. The prices of the main commodities – oil, gas and metals – were kept far below the market level.[22] This turned out to be a major shortcoming of the reform because a small number of skilful commercial operators seized on this opportunity. They bought these commodities from the state companies that produced them at a very low state price and then exported them by somehow acquiring export quotas and licenses. Eventually, they sold the commodities abroad and channelled the revenue into their private offshore trading companies, typically located in Cyprus because of an old Soviet double-taxation agreement with Cyprus. Thus, their business was not investment but speculation in commodities.

Before the adoption of the Soviet Law on Cooperatives in May 1988, a common Soviet view was that Russians had been deprived of their entrepreneurial genes since Joseph Stalin had systematically executed the Russian entrepreneurial elite, but reality turned out to be very different. In January 1992, President Yeltsin signed a decree allowing anybody to go out into the street at any time to sell anything at any price. Following the successful example of Poland in January 1990 hundreds of thousands of Russians went out in the middle of the frigid Russian winter and started selling anything.[23] It turned out that Russians had a lot of entrepreneurial genes. In the early 1990s, hundreds of thousands of new private enterprises were created, most of all at the beginning. This was an enormous force in every post-communist country.[24]

The conclusions concerning the liberalisation of prices, markets and entrepreneurship can be summarised as follows. You never reach much higher than you jump at the outset. The faster and more radical the start of liberalisation, the more likely it is to hold.[25] The explanation is that the political issue was to beat the incumbents, which was best achieved at speed.[26]

Conclusions on Liberalisation

1. It was comparatively easy to liberalise prices. After they had been liberalised, they were respected. The big exception was major commodity prices, essentially, oil, gas and electricity, because they offered major rents to the powerful and well connected.

2. After prices had been liberalised, a normal domestic market was established and it has persisted.

3. The initial entrepreneurial spirit exceeded all expectations. While it has lasted, it has declined over time as the controlling state bureaucracy has come back.

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21 Slay, Ben and Vladimir Capelik (1997), "The Struggle for Natural Monopoly Reform in Russia," Post-Soviet Geography and Economics 38 (7): 396-429.

22 Ibid, Åslund (1995).

23 Balcerowicz, Leszek (2014), "Poland: Stabilization and Reforms under Extraordinary and Normal Policies," in Åslund and Djankov (2014), pp. 17-38.

24 Johnson, Simon (1994), "Private Business in Eastern Europe," in Olivier Jean Blanchard, Kenneth A. Froot and Jeffrey D. Sachs, eds., *The Transition in Eastern Europe*. Chicago: The University of Chicago Press, pp. 245-90.

25 Åslund, Anders (2013), *How Capitalism Was Built: The Transformation of Central and Eastern Europe, Russia, the Caucasus, and Central Asia*. 2nd edition, New York: Cambridge University Press, 112-114.

26 Drazen, Allen and Vittorio Grilli. 1993. The Benefit of Crises for Economic Reforms. *American Economic Review* 83, 3: 598-607.

4. The Anti-Monopoly Committee in Russia, as elsewhere in the former Soviet Union, did not promote competition but monopoly. In the early stages of deregulation, far-reaching liberalisation is more effective than state attempts to check unfair competition.

Privatisation

The most difficult part of the transition from a state-dominated economy to a free-market economy was privatisation. On the one hand, it was necessary. On the other, it was impossible to avoid arousing much popular dissatisfaction. While the economic results have usually been highly beneficial, every country that has carried out any privatisation has ended up with plenty of political and legal problems.

Far-reaching privatisation was necessary for many reasons. The fundamental aim was to break the all-embracing state control of almost all enterprises, which was vital for the creation of a market economy and democracy. The large state subsidies of enterprises had to be reduced. Enterprise managers should be evaluated on the basis of their economic performance, not on their political or personal loyalty. Enterprise restructuring, including the closure of failing enterprises, had to be facilitated. The market should be opened to new entrepreneurs and foreign investment should be facilitated. Ultimately, privatisation was supposed to lead to a depoliticised and far more efficient economy.[27]

There were many aspects of privatisation: justice, economics, politics and law. Before privatisation, Russians were highly positive. Most of them expected to obtain significant wealth as citizens, workers or tenants. After the privatisation, they were greatly disappointed because they had received far less than they had hoped for. Furthermore, they perceived that many undeserving people had received excessive wealth. Such disappointments could not be avoided because no privatisation can be fair, although the government was rightly blamed for having encouraged people's expectations of swift enrichment. In each post-communist country, most people have been disappointed with the outcome of privatisation, but especially so in Russia because of a stunning wealth concentration among about a hundred billionaires. Moreover, it has become increasingly difficult to become an entrepreneur and those entrepreneurs who make it encounter a glass ceiling or police harassment when they become too successful.

The most successful development of new enterprises took place in the early transition in 1992-93 when state regulation was eased, partially because of official liberalisation and partially because of a temporarily reduced state capacity to regulate. The number of new enterprises has tended to be lower each year because of increased bureaucratisation. It was vital for entrepreneurs to exploit the open window of early liberalisation.[28]

The privatisation of small shops and workshops was the easiest part. It was carried out by local authorities. The original intention was to auction them out to the highest bidders. In reality, however, they were usually taken over by the incumbent manager at a low price, but the important thing was that they were privatised fast so that they could start to act independently and reinforce the already existing market. In order to accomplish this, local authorities had to be given full responsibility for small enterprises and receive the revenue from their sale to have an incentive to sell. For the functioning of the new businesses, it was desirable for the state authorities to clarify property rights and not maintain unnecessary liens.[29]

The privatisation of large and medium-sized enterprises was much more difficult. Many, probably most, of these enterprises were not viable. Their technology was usually obsolete and their size suboptimal. Russia had far too many medium-sized enterprises as its production was so inefficient. The Russian privatisers wanted to privatise them for many reasons. They wanted to depoliticise the enterprises and

27 The Russian privatisation programme was published in a book by the key policy advisors: Boycko, Maxim, Andrei Shleifer and Robert W. Vishny (1995), *Privatizing Russia*. Cambridge, MA: MIT Press. The experience was summed up in another book edited by Anatly Chubais, Russia's privatization minister: Chubais, Anatoly B., ed. (1999), *Privatizatsiya po-rossiiski (Privatisation in a Russian Way)*. Moscow: Vagrius.

28 Johnson, Simon (1994), "Private Business in Eastern Europe," in Olivier Jean Blanchard, Kenneth A. Froot and Jeffrey D. Sachs, eds., *The Transition in Eastern Europe*. Chicago: The University of Chicago Press, pp. 245-90.

29 Frydman, Roman, Andrzej Rapaczynski and Joel Turkewitz (1994), *Small Privatization.* Budapest: Central European University Press.

their management so that incompetent state manages would lose their jobs. Furthermore, the liberals did not want to subsidise inefficient state companies and they wanted to promote efficient enterprise managers. They also hoped that private owners would close down obsolete lossmaking enterprises.[30]

The main Russian privatisation was carried out from 1992 until 1995. It involved over 16,000 large and medium-sized enterprises. It was called voucher privatisation. All Russians had received one voucher for free, but only about a fifth of the shares in these enterprises was sold at voucher auctions. Many sold their vouchers for a pittance. Budding investors bought up many vouchers and seized control of many old enterprises. A fifth of the shares were given to the managers to persuade them to play along, and two-fifths of the shares to the employees, which were usually soon sold either to outsiders through the swiftly developed stock market or to their chief executive. The state usually retained the last fifth of the shares in each company. Typically, either a company just collapsed, which became possible thanks to privatisation, or its ownership was consolidated, mostly to the old manager but sometimes to new outside owners.[31]

The most controversial privatisations occurred in the last quarter of 1995. They involved only twelve enterprises but they were big. Of these only three changed ownership control, the Yukos Oil Company, the Sibneft Oil company and Norilsk Nickel. They were sold to young outside financial specialists. Yukos was confiscated by the Russian state from 2003 to 2005 in an irregular court process. Sibneft was bought by the Russian state company Gazprom at a price that was considered too high in 2005. Norilsk Nickel remains private. These three companies were outstanding in terms of enterprise restructuring and increased efficiency, but that did not swing public opinion. People accepted unfair insider privatisation, as in Gazprom, but they did not accept that outsiders made fortunes by providing the Russian economy with far greater value. Russia established lively stock exchanges early on, but they have deteriorated since 2008 because of poor corporate governance caused by excessive state interference and poor rule of law.[32]

Since 2003 with the confiscation of Yukos, the Kremlin has pursued a policy of renationalisation, promoting the idea that big companies, especially resource companies should be owned by the state, and according to opinion polls the public has responded positively to this message. Roughly half of the Russian economy remains under state control.[33] However, the Putin regime has transferred a substantial share of the source companies to close friends of the president. The concentration of ownership by the state, Putin's friends and aging oligarchs is an important cause of Russia's economy having been nearly stagnant since 2009 and completely stagnant since 2014.

Conclusions Concerning Privatisation:

The privatisation of small state enterprises was the easy part. Ideally, they should have been auctioned off locally, but in practice the incumbent manager tended to take over for a low price. It did not really matter how small enterprises were privatised as long as they were truly privatised. The greater the freedom and clarity of property rights of the privatised enterprises, the better the economic results were.

Regardless of how the big companies were privatised and how well they did economically, their privatisation tended to be unpopular because of the fortunes the newly rich owners made. Given substantial state interference and the poor rule of law, corporate governance has not improved but deteriorated. Ninety percent of the oil companies in terms of production were privatised, but currently the state has become the dominant owner because it has taken over privatised oil companies by force.

30 Boycko, Maxim, Andrei Shleifer and Robert W. Vishny (1995), *Privatizing Russia*. Cambridge, MA: MIT Press.

31 Blasi, Joseph R., Maya Kroumova and Douglas Kruse (1997), *Kremlin Capitalism: Privatizing the Russian Economy*. Ithaca, NY: Cornell University Press.

32 Chrystia Freeland describes how the loans-for-shares privatisation took place, Freeland, Chrystia (2000), *Sale of the Century: Russia's Wild Ride from Communism to Capitalism*. New York: Crown Business; Andrei Shleifer and Daniel Treisman assess the great success of these enterprises, Shleifer, Andrei and Daniel Treisman (2004), A Normal Country. *Foreign Affairs* 83, 2: 20-38); while Stephen Fortescue offers an overall positive economic perspective, Fortescue, Stephen (2006), *Russia's Oil Barons and Metal Magnates*, New York: Palgrave McMillan; Kokh, Alfred (1998), *The Selling of the Soviet Empire*. New York: Liberty Publishing House.

33 Radygin, Aleksandr, et al. (2018), *Effektivnoe upravlenie gosudarstvennoi sobstvennost'yu v 2018-2024 gg. i do 2035 g. (Efficient Management of State Property in 2018-2024 and to 2035)*, Moscow: Centr strategicheskikh razrabotok, January; EBRD (European Bank for Reconstruction and Development) (2020), *Transition Report 2020.* London: EBRD.

The Particularities of Oil

A major source of rents, such as oil and gas, poses a major challenge to any country. Most countries dominated by oil revenue are authoritarian because it is easy for the ruling elite to concentrate the oil rents among themselves.[34]

The most difficult part of Russia's transition was not the production of oil but the export of oil and gas. This started before the end of the Soviet Union. Russian state oil companies were entitled to sell their oil to private middlemen at the set low oil price, and the oil traders could export the oil to the world market. In December 1991, a person with good connections with the oil industry could buy oil in Russia for the state-controlled price of as little as $0.50 a barrel and sell it abroad at the global market prices of about $100 a barrel. This is how all the budding oligarchs made their fortunes. With the right contacts, they could finance this with Russian bank loans at not more than 50 percent a year, while Russia's inflation in 1992 was 2,500 percent.[35] This was how the big early oligarchic fortunes were made.[36]

An initial aim of the Russian reformers was to liberalise oil and gas prices so that they would rise to the world market level in order to deprive energy traders of large easy fortunes made through elementary arbitrage between very low state-controlled domestic prices and much higher free world market prices.[37] At the time of the big price liberalisation in January 1992, the leading reformer, First Deputy Prime Minister Yegor Gaidar, argued for full price liberalisation also for oil.[38] President Yeltsin, however, listened to the old industrial general directors, who thought too high an oil price would stop the whole of Russian industry. Therefore, Yeltsin decided that a fivefold price increase would suffice, although it made little difference as inflation was 2,500 percent. Because of the price controls for oil, oil exports had to be restricted, but such controls were easily overcome with private payments. As a consequence, anybody involved in the oil trade was worth their weight in gold in the depressed years of 1991-93 while the people suffered. From 1994, the people who had made their money from oil exports effectively bought Russian politics.

Oil production plummeted by half from 1989 to 1995 for many reasons ranging from old oil fields to corrupt management. Traditionally, the Soviet Union had one oil ministry and one gas ministry, which each ran their industries as one company. The reformers wanted to break up the oil and gas ministries into reasonably sized competing companies. From 1992 to 1995, all the big oil companies in Russia were split up and privatised, but then another problem arose. The new main owners of the oil companies became billionaires within several years, and they bought the state. In 1995, two of the biggest and worst managed oil companies, Yukos and Sibneft, were privatised. The first task of the new managements was to secure control of the companies. Because of poor corporate governance and rule of law, they considered it necessary to consolidate their ownership of the whole companies, which effectively took four years. From 1999, the new managements carried out stellar financial and technical restructuring in both companies. As a consequence, Russia's oil production took off and it increased by 50 percent from 1999 to 2004. Nevertheless, Russians were more concerned about the impressive fortunes made by the new oligarchs.[39] People favoured their nationalisation, which took place in 2004-

The Russian gas sector experienced the opposite problem. The Russian Ministry of the Gas Industry was transformed into one company, Gazprom, which was partially privatised by insiders in late 1993 because its old chief executive was the Russian Prime Minister Viktor Chernomyrdin. Gazprom maintained all its privileges and monopolies for many years. It felt no pressure to modernise or rationalise but became a haven of corruption. The Russian gas fields had been developed later than the oil fields

34 Gaddy, Clifford G. and Barry W. Ickes (2005), Resource Rents and the Russian Economy. *Eurasian Geography and Economics* 46, 8: 559-583.

35 Ibid, Åslund (2007).

36 Hellman, Joel S. (1998), "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions," *World Politics,* 50: 203-234.

37 The main work on Russia's oil policy is Gustafson, Thane (2012), *Wheel of Fortune: The Battle for Oil and Power in Russia.* Cambridge, MA: Belknap Press of Harvard University Press.

38 Gaidar, Yegor T. (1999), *Days of Defeat and Victory*. Seattle, WA: University of Washington Press. So did I as an advisor to the Russian government at that time.

39 Shleifer, Andrei and Daniel Treisman (2004), A Normal Country. *Foreign Affairs* 83, 2: 20-38.

and Russia had an abundance of gas. Unlike oil production, which fell and rose, gas production was roughly constant for many years. While Russia developed an oil market, the gas market did not evolve and gas prices stayed strictly regulated by the state. The marketisation generated depoliticisation of oil. Also internationally, gas was much more politicised than oil.[40]

The reformers also wanted to tax oil and gas heavily, but they did not know how, and natural resources require special taxation at source under separate rules. This can be done in different ways depending on ownership and trade patterns. Initially, the Russian government tried to tax oil and gas at source through royalties and profit taxes, but it largely failed to collect these taxes. The most effective way of taxing oil revenue turned out to be through export taxes, although this caused oil prices to be lower in Russia than on the world market. The IMF opposed this kind of taxation for fear of corruption but accepted it when the Russian government proved that it worked well. Today, Russia imposes a higher marginal tax on oil revenue when the oil price passes a certain level.

Conclusions concerning the transition of the Russian oil and gas sectors

1. It was vital to liberalise domestic oil prices and exports of oil early on to stop the vast arbitrage rents that arose for those who could buy oil domestically at a low controlled state price and export it on the world market. This was the main source of big fortunes in Russia.

2. The early splitting up of oil companies and their privatisation led to fast restructuring and modernisation that brought eminent economic results. However, their property rights did not become publicly recognised, rendering them liable to renationalisation through confiscation or state purchase. After their renationalisation, the positive developments gradually stalled, indicating that the renationalisation was economically harmful.

3. Economies of scale in oil and gas are great. Moreover, successful restructuring required strong management, which called for a consolidation of ownership. As a consequence, a few well-placed individuals became very rich in each successful oil company regardless of how the initial privatisation had taken place. From 2000, however, the new owners opted for transparency and good corporate governance to be able to benefit from rising stock prices.

4. Gazprom remained state-owned and attempts to improve its corporate governance have fallen short. It has become the main source of enrichment of the state elite.

5. The Russian government found that the most effective way of taxing oil revenue was through export taxes and taxes related to the oil price.

Property Rights

The most important shortcoming of the Russian reforms was their failure to establish secure private property rights. An important reason for this shortfall was that almost all the top reformers were economists not lawyers. Two countries that derived from the Soviet Union actually succeeded. Both had lawyers among their top reformers. The first was Estonia, which did so in the early 1990s,[41] and the second was Georgia, which did so after its Rose Revolution in 2003.[42] They carried out major judicial reforms from the top down, starting by sacking all the top judges and appointing new honest and competent staff.

As economists, the Russian reformers started at the opposite end by distributing property as fast as possible. Their idea was that the problems of property rights would be sorted out as soon as new owners existed, because the new owners would demand the development of a strong judicial system to

40 The best book on the Russian gas industry is Gustafson, Thane (2020), *The Bridge: Natural Gas in a Redivided Europe.* Cambridge, MA: Harvard University Press. A stunning early account of its corruption is Nemtsov, Boris and Vladimir Milov (2008), *Putin i Gazprom (Putin and Gazprom)*, Novaya Gazeta, Moscow.

41 Laar, Mart (2002), *Little Country That Could*. London: Centre for Research into Post-Communist Economies.

42 Saakashvili, Mikheil and Kakha Bendukidze (2014), “Georgia: the Most Radical Catch-Up Reform,” in Åslund and Djankov (2014), pp. 149-164.

defend their property rights. They also presumed that the new owners would push for good corporate governance legislation and practices.

Unfortunately, this did not work. A Russian Professor at the University of Chicago, Konstantin Sonin, has explained why in an article called ‘Why the Rich May Favor Poor Protection of Property Rights.’ The wealthy did not benefit from the rule of law when they were making their fortunes. On the contrary, they could cheaply acquire the assets of businessmen with less wealth by purchasing state officials and courts. After retirement, they would move to a Western country with strong rule of law that protected their assets. Therefore, they had no reason to stand up for property rights in Russia, which would only irritate not very honest rulers.[43] Empirical observations support this thesis. According to Transparency International, Russia has not improved its control of corruption over the last decade,.[44] Another piece of evidence is that Russian private financial assets abroad are currently assessed at about $1 trillion. Wealthy Russians do not keep their savings in Russia.[45] Therefore, they do not lobby for the rule of law in Russia.

Russia started with a difficult judicial legacy because law served the state rather than society. Since the time of Tsar Peter the Great in the early 18th century, the general prosecutor had been superior to the judges. This tradition continued under communism and remains strong, although it has been weakened by reforms.46 Although legal reform was not the focus of the Russian reformers, a fair amount was achieved in the 1990s and a major judicial reform was carried out in 2002. While it looked good on paper, its essence was to transfer judicial power from the regional governors to the presidential administration, centralising state control over the judiciary. Jordan Gans-Morse observes that Russia’s judicial system was at its best in the early 2000s and then deteriorated.[47]

As a consequence, Russia does not have an independent credible judicial system and property rights are weak. Companies, whose owners are not sufficiently well connected politically, can easily become subject to corporate raiding, i.e. theft. They are all controlled by the central state powers through informal ‘telephone law,’ meaning that a senior state official may call the relevant prosecutor or judge and tell them what the verdict should be.

Because of poor corporate governance and a substandard judicial system, the new dominant owners of large enterprises did not want annoying minority shareholders. They preferred to ease them out through legally dubious share dilutions. As the Kremlin consolidated its power, it wanted to control the big businessmen and their companies, which was much easier without any independent courts or shareholder democracy. The result was large capital outflows, low investment ratios and ever smaller foreign direct investment, which all hold back economic growth. Russia maintains a stock market, but it peaked in May 2008 and its current level measured in US dollars is about half of that at its height.

Unfortunately, the international community has no relevant body for building the rule of law, so no assistance is around the corner.

43 Sonin, Konstantin (2003), Why the Rich May Favor Poor Protection of Property Rights. *Journal of Comparative Economics*, vol. 31. no. 4: 718-731; Havrylyshyn, Oleh (2020), *Present at the Transition*. New York: Cambridge University Press, 194.

44 Transparency International (2020), Corruption Perceptions Index. http://transparency.org.

45 Novokmet, Filip, Thomas Piketty and Gabriel Zucman (2017), *The From Soviets to Oligarchs: Inequality and Property in Russia, 1905-2016*. NBER Working Paper no. 23712. Cambridge, MA: National Bureau of Economic Research, August; Åslund, Anders (2020), *Russia’s Crony Capitalism*, New Haven: Yale University Press.

46 Pomeranz, William E., *Law and the Russian State: Russia’s Legal Evolution from Peter the Great to Vladimir Putin*. New York: Bloomsbury.

47 Gans-Morse, Jordan (2012), Threats to Property Rights in Russia: From Private Coercion to State Aggression, *Post-Soviet Affairs* 28, 3: 263-295.

Conclusions: What Can Libya Learn from Russia?

It appears as if Libya could greatly benefit from Russia's experiences in its early post-communist transition, partly because of what worked and partly because of what did not. Fortunately, Libya's macroeconomic problems are far less severe than those of Russia in 1991, which should make the Libyan transition much easier. Libya's inflation in 2020 was only 22 percent. Several other issues, however, seem quite similar, and here the Russian experience could be instructive.

Hopefully, this paper has outlined what Libya can learn from Russia's successes and failures in its early transition from complete state control to a freer market economy. The clearest success was the creation of a market economy through radical early liberalisation of prices, markets and enterprise. Similarly, the early sell-off of small enterprises was successful. While Russia took some time to find its way on macroeconomic stabilisation, the value of a strong ministry of finance and central bank and of a simple tax system has become evident.

In other areas, Russia's experience has not been positive. Whereas Russia's privatisation of big companies, including the oil companies, led to economic successes, it was not politically sustainable. The question arises whether it would have been better to just split the oil companies and keep them in state hands for some time while imposing strict corporate governance. The maintenance of a state monopoly of gas has been worse, as it appears to have generated one of the greatest sources of corruption in the world. Russia's failure in judicial reform is a warning to all. Stable economic growth can hardly be maintained without reasonably reliable property rights.

Finally, there are areas where Russia's experience might not be very relevant to Libya. Hopefully, Libya will not face such a terrible financial crisis as Russia did in 1991-92. Russia opted for a floating exchange rate but the oil states in the Gulf chose fixed exchange rates, offering no clear policy suggestion. Russia has succeeded in taxing oil wealth through export taxes and taxes linked to the oil price. It is not obvious that this is the best choice for Libya. The question is what form of tax collection is most practical and effective.

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