

# Dividing the Spoils

## Pensions, Privatization, and Reform in Russia's Transition

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The gains from the transition in post-communist Russia were captured by the new managerial class, which won rents from the state in the form of privatized enterprises, state subsidies, credits, and opportunities for tax evasion. Those rents reduced state revenues that could have supported social policy — including pension reform, which in turn could have fueled industrial restructuring. With neither pension reform nor industrial restructuring, Russia's economy has continued to shrink.



## Summary findings

Kapstein and Milanovic present a political economy model in which policy is the outcome of an interaction between three actors: government (G), managers and workers (W), and transfer recipients (P).

The government's objective is to stay in power, for which it needs the support of either P or W. It can choose slow privatization with little asset stripping and significant taxation, thus protecting the fiscal base out of which it pays pensioners relatively well (as in Poland). Or it can give away assets and tax exemptions to managers and workers, who then bankroll it and deliver the vote, but it thereby loses taxes and pays little to pensioners (as in Russia).

The authors apply this model to Russia for the period 1992–96. An empirical analysis of electoral behavior in the 1996 presidential election shows that the likelihood of someone voting for Yeltsin did not depend on that person's socioeconomic group per se.

Those who tended to vote for Yeltsin were richer, younger, and better educated and had more favorable

expectations of the future. Entrepreneurs, who had more of these characteristics, tended to vote for Yeltsin as a result, while pensioners, who had almost none, tended to vote against Yeltsin.

Unlike Poland, Russia failed to create pluralist politics in the early years of the transition, so no effective counterbalance emerged to offset managerial rent-seeking and the state was easily captured by well-organized industrial interests. The political elite were reelected because industrial interests bankrolled their campaign in return for promises that government largesse would continue to flow.

Russia shows vividly how political economy affects policymaking, because of how openly and flagrantly government granted favors in return for electoral support. But special interests, venal bureaucrats, and the exchange of favors tend to be the rule, not the exception, elsewhere as well.

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**DIVIDING THE SPOILS:  
PENSIONS, PRIVATIZATION AND REFORM IN RUSSIA'S TRANSITION**

*Ethan B. Kapstein and Branko Milanovic<sup>1</sup>*

Ох тѣжелая эта работа  
Из балота тащит бегемота

(Oh, hard is that task  
to pull the Goliath out of the swamp)  
[Children's rhyme]

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## *1. The Political Economy of Social Policy*

“People cannot live on 234 rubles (\$9.75) per month.” So spoke Russian Prime Minister Yevgeni Primakov in March 1999 about the plight of some 4 million of his country’s elderly citizens, who must survive on the minimum pension.<sup>2</sup> And of course those who actually receive even this pittance with any regularity must consider themselves among the fortunate few. Pension arrears, coupled with systemic problems in the postal and banking systems, mean that millions of Russians receive no official transfers at all, month after month.

The collapse of the social safety net provides perhaps the most visible and tragic example of Russia’s struggle with economic transition. But beyond the normative concerns that the increase in poverty must generate, the particular fate of Russia’s pensioners also raises significant issues for students of comparative political economy. For one thing, while pensioners represent a similar percentage of the electorate—about 40 percent—across the European post-Communist transition states, they have met with very different economic fates, ranging from relative (when compared to workers) income gains in Poland to a severe drop in the Czech Republic, with Russia falling between these extremes. Indeed, regression analysis taken across the entire spectrum of transition countries has revealed that there is no apparent “relation between the number of retirees and the benefits they earn...”<sup>3</sup>

What, then explains the differences in outcomes that we observe from one country to another? And if Russian pensioners (among others), despite their growing numbers, have not been the visible winners from transition, who has been, and why? These are the questions we seek to address in this study.

We believe that our findings carry implications for understanding both the economic policy-making process in the transition countries and for the *sequencing* of the reforms they adopted as well. In the early stages of economic policy reform, social policy generally took a back seat in favor of price liberalization, macroeconomic stabilization and, in some countries, privatization. These choices, we would argue, were not driven simply by a textbook understanding of what constituted “best practices” in market-creating processes, but rather reflected the *political economy* of transition regimes, meaning the particular interests and institutions that influenced policy outcomes.

In the specific case at hand, we raise as a counterfactual the possibility that privatization revenues (both “one shot” and subsequently through tax payments) might have been conceptualized by the Russian government as a potentially important source of additional financing for pension system reform; reform which, in turn, could have contributed to the deepening of capital markets and thus become a source of funding for subsequent restructuring of newly privatized enterprises. Pension reform and enterprise restructuring, in short, might have formed a virtuous circle, as is occurring to some

<sup>2</sup> Izvestia Press Digest, 19 March 1999.

<sup>3</sup> Barbara Fakin and Alain de Crombrughe, “Fiscal Adjustments in Transition Economies: Social Transfers and Efficiency of Public Spending,” *World Bank Policy Research Paper 27/3*, 1997, p. 17.

degree in Poland. In Russia, however, that course was not taken, and instead the rents associated with privatization disappeared into managers' (and, to a much lesser degree, workers') pockets. Today, with the state effectively bankrupt, pensioners often find themselves waiting at the post office and savings bank (*Sberbank*) for their sequestered checks to be released.

The paper is organized as follows. In Section 2, we present a formal model of social policy formulation with three interested actors: transfer recipients, workers and managers, and the government ("the authorities", or the political elite). Section 3 gives a narrative of privatization and pension policies as pursued by the Russian authorities in the period 1992-96, and explains how they stemmed from a certain electoral strategy. Section 4 investigates, based on detailed empirical data from VCIOM (All-Russian Center for Public Opinion Research), whether the strategy worked. Section 5 gives our conclusions.

## ***2. A Model of Social Policy Formulation***

It is now clear, some ten years after the onset of the transition process, that social policy reform should not be treated apart from other economic policy measures, such as macroeconomic stabilization, price liberalization, and privatization. This is because these market-oriented policies themselves had distributional consequences for all members of society, both rich and poor. Suffice it to mention in this context Russian voucher privatization, which greatly enriched the managerial elite. *Indeed, our argument in this paper is that the way in which economic reform was carried out in Russia had significant, and not unintended, distributional consequences.*

To study these distributive issues more easily, we look at social policy formulation in terms of three groups of actors:

1) "Rent-recipients," who are workers and managers of state-owned enterprises (SOEs), plus entrepreneurs not working for SOEs. We denote this group workers, W. We consider them jointly because, once the government takes a decision for mass privatization, their common interest at the outset is to receive SOEs and other state property at the lowest price, and to obtain tax breaks and subsidies, all with the objective of maximizing income flows. (We recognize, of course, that over the longer-term interests of workers and managers may diverge, but we work initially with a single-period model).

2) "Transfer-recipients" which includes pensioners, recipients of other social transfers (e.g. the unemployed and destitute), and budget sphere employees (e.g. bureaucrats, soldiers, doctors, and teachers); we call them all pensioners, P. The common feature of P is that their incomes depend entirely or to a large extent on government transfers, which in turn depend on tax collection.

3) Elected officials in government, denoted G, who have three assets which they "sell" to voters: state property; rents (including tax exemptions and subsidies); and transfers. They sell the first two to workers; the last to pensioners. In order to get the last

one (transfers) they need to assess taxes on workers. Politicians sell these assets in exchange for electoral support (votes and campaign contributions).

We consider the entire voting population of a country to consist of first two groups (Ws and Ps) only.<sup>4</sup>

W's objective function is to maximize capital gains and tax exemptions. Capital gain ( $g$ ) is defined as  $g = \pi(K^* - K)$ , where  $K^*$  is market value of state assets,  $K$  = actual price at which these assets are purchased by workers, and  $\pi$  = the share of state assets that are privatized. Tax exemptions ( $e$ ) are defined as the difference between the statutory  $t^*$  and actual tax rates,  $t$ ,  $e = t^* - t$ . To workers, the only tax exemptions that matter are those on privatized firms (i.e. firms they own). Total amount of tax exemptions will thus be

$$(1) \quad b = \pi Y(t^* - t)$$

where  $Y$  = total income (GDP) of the economy, and  $\pi Y$  = privatized part of the economy.<sup>5</sup>

Note that the capital gain is a one-shot gain: once an enterprise is given away for free, the government loses this asset. Tax exemptions, in contrast, are a "renewable" asset: the government can "sell" them one year after another. In a multi-period model, we should distinguish between the two. For simplicity, however, we work here with a single-period model where the two are equivalent.  $\pi$  can then be interpreted as speed of privatization, that is the share of assets that the government will keep on privatizing year after year.

Workers' electoral support  $E_w$  is an increasing function in the sum of  $g$  and  $b$ . We write workers' electoral support as:

$$(1) \quad E_w = \alpha(g + b)$$

where  $\alpha' > 0$  and  $\alpha$  (in theory) may range from 0 (no one among workers supports the government) to 1 (all workers support the government).

Obviously, workers' objective is maximization of  $g + b$ . In one extreme case, the government could give all state enterprises to workers for free and impose no taxes on new private enterprises. At that point  $\alpha$  would reach its maximum. Thus, at  $g = K^*$  and  $b = t^*$ ,  $E_w = 1$ . At the other extreme, when both capital gains and tax exemptions are nil, electoral support may be zero or some very low value.

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<sup>4</sup> Pensioners alone represents about 20-25 percent of the population in transition economies; the employees in the budget-sphere represent another 10 percent. Workers and managers of (non-agricultural) SOEs are, at the beginning of the transition, 30-40 percent of the population. Together, the two groups thus account for almost 4/5 of the all voters.

<sup>5</sup> We assume that once  $\pi K$  of the economy is privatized, it produces  $\pi Y$  of output (i.e. the capital-output ratio is the same in both private and state sector).

For pensioners, the objective function is maximization of their pensions, other transfers, and wages received by the budget-sphere workers. We denote all these three by  $p$ . Their electoral support,  $E_p$  is an increasing function of  $p$ :

$$(2) \quad E_p = \beta(p)$$

where  $\beta$  function translates, like  $\alpha$  before, money into electoral support ( $\beta' > 0$ ). For some very high  $p$ ,  $E_p = 1$ ; for some very low  $p$ ,  $E_p$  is very small or zero.

Now, the objective of the government is, of course, to stay in power. In order to do so, more than 50 percent of combined workers and pensioners must vote for it. If we denote by  $S_w$  and  $S_p$  the shares of respectively workers and pensioners in total voting population, we have

$$(3) \quad \alpha S_w + \beta S_p > 0.5$$

for the government to stay in power.

The link between workers and pensioners objectives is provided by taxation. In order for the government to be able to pay pensioners, it must be able to collect taxes. (We disregard other possible sources of financing, like foreign loans, custom duties etc. Some justification for this may be provided by observing that these additional sources of revenues are used for other public sector non-wage and non-transfer payments, e.g. public infrastructure investments.) By definition, total expenditures on pensions are  $P_p$ . They have to equal tax revenues. Thus,

$$(4) \quad P_p = (1-\pi)t^*Y + \pi Y = [t^* - e\pi] Y$$

which shows that total tax revenues are obtained by charging statutory taxes on the non-private part of the economy  $(1-\pi)t^*Y$ , and (possibly) lower taxes on the privatized part. Taking for a moment income ( $Y$ ), number of pensioners ( $P$ ) and statutory tax rates ( $t^*$ ) as given, equation (4) shows that once the government decides on a target  $p$ , this uniquely determines the value of  $e\pi$ .

Suppose now that the target  $p$  which gives the government a certain target level of pensioners' electoral support is consistent only with  $t^*Y$ . In other words, the desired pension expenditures ( $P_p$ ) are equal to statutory taxes imposed on the entire GDP ( $t^*Y$ ). This implies (see equation 4 above) that either tax exemptions must be nil ( $e=0$ ) or there must be no privatization ( $\pi=0$ ). But without privatization (and capital gains), and without tax exemptions for the privatized firms, the electoral support of workers is at the minimum, and since workers are (almost) always more numerous than pensioners (but not numerous enough to ensure a majority), government re-election may not be assured. Equation (3) may not be satisfied. What can the government do then? It can start privatizing state assets at below market prices thus moving upwards along the workers' electoral support function. If this is not sufficient to garner sufficient support, it has three choices:

- (a) speed up privatization (increase  $\pi$ );

(b) allow for greater capital gains  $g$  (reduce the price at which assets are privatized);

(c) increase tax exemptions (increase  $e$ ).

Note that (a)-(c) all increase the value of equation (1), thus raising workers' electoral support.

How far the government would go in that direction depends on the electoral support functions of workers and pensioners ( $\alpha$  and  $\beta$ ). As  $e$  and  $p$  increase and the government gains more support from workers, the right-hand side of (4) is less—tax revenues decline—and thus the money available for pensions decreases and pensioners' electoral support declines. So long as the marginal electoral loss from a unit decrease in pensions is more than offset by a marginal electoral gain from a unit increase in tax exemptions and privatization, the government will proceed with privatization and tax exemptions. In addition, these electoral gains and losses must be weighted by the respective voting shares of pensioners and workers (see equation 3). If, for example, there are few pensioners even a significant loss of their support can be easily offset by a small increase in workers' electoral support function.



### 3. *Interaction between privatization, pension policy, and electoral strategy*

The utility of political economy models of policy-making is powerfully illustrated by the Russian case, and particularly in the relationship between pensioners, managers, and the government. In the new democracy, managers and elected officials have formed what might be called a “symbiotic” relationship. Simply stated, in the post-communist Russia, the President has needed to win popular votes to remain in office; votes that are costly to obtain in a country this large, diverse, and politically fragmented. The funds for that electoral activity have come largely from the entrepreneurial class, as a reward for the “gifts” it had received from the administration in the form of subsidized credits, deferred tax payments, and other rents, including the gains from privatization. In short, the concentrated interests of the winners, especially the managers and workers in privatized enterprises, have overwhelmed those of the politically unorganized pensioners, who despite their large numbers appear to face significant problems of collective action. Living often in poverty in far-flung rural districts, and lacking information about how to influence the electoral system, these numerous pensioners have yet to create a “grey power” lobbying group, as their demographic cousins have done in many other countries.

By way of contrast, Russian politicians faced a various different polity than the one existing in Poland, where well-organized interests—unions and farmers, for example—could, to a larger degree, counteract the power of rent-seeking managers. The Poland-Russia difference may, in part at least, have its roots in pre-transition politics. While in Poland a long tradition of worker management, the emergence of “Solidarity” in the early 1980’s, and at least the nominal existence of a multi-party system,<sup>6</sup> provided the ground for the growth of organized interest groups, none of that existed in Russia, except an informal and unchecked power of managers.

The model of political economy sketched in the previous section conceptualizes policy as an endogenous process—an output produced by self-interested politicians. It is our contention that the Yeltsin government pursued a strategy of maximizing votes from managers and workers, which meant tax breaks (in the form of state acceptance of tax avoidance), credits, and subsidies, a strategy that effectively necessitated abandoning pensioners and their claims on state transfers in the process.

In this analysis of winners and losers in the Russian transition, our approach builds closely on the work of Joel Hellman and provides further empirical support for his general argument. In his important article on Russian political economy during the transition era, Hellman made the case that “surprisingly, the politics of postcommunist economic reforms *has not* (italics added) been dominated by the traditional short-term losers of economic transition—striking workers, resentful former state bureaucrats, impoverished pensioners, or armies of the unemployed. Instead, the most common obstacles to the progress of economic reform...have come from very different sources:

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<sup>6</sup> It is often forgotten that the first non-Communist government in Poland, led by Tadeusz Mazowiecki, was made possible by the defection of one of the erstwhile satellites of the Communist party (the Peasants party) into the Solidarity camp.

from enterprise insiders who have become new owners only to strip their firms' assets; from commercial bankers...from local officials...and from so-called mafiosi..." These winners, Hellman argues, "have frequently attempted to block specific advances in the reform process that threaten to eliminate the special advantages and market distortions upon which their own early reform gains were based."<sup>7</sup> We go even further, asserting that these groups have successfully siphoned off the gains from transition that were up for grabs, and that could have gone instead to transfer recipients, including pensioners.

Our work also provides further evidence for the relative weakness of Russia's civil society.<sup>8</sup> As Adam Przeworski has argued, "if democracy is to be consolidated, the role of competition should be to dissipate...profits (from transition) rather than turn them into permanent rents."<sup>9</sup> Competition, however, requires the presence of organized interests that *can* contest one another, forcing politicians to serve, not as neutral arbiters, but as balancing forces in their own self-interest of retaining power<sup>10</sup>

In Russia, with its lack of civil society and *organized* contestation, no counter-balance to rent-seeking by the managerial class existed. Russia's organized labor, in contrast to e.g. Poland, is "disoriented and disorganized." Small business interests, that represent an important economic interest group in many industrial democracies, find themselves in Russia "weak, disorganized, and depoliticized..." Simply stated, Russia has lacked the contested domestic politics found in Poland, to the detriment of its economic and political development<sup>11</sup>

#### *Winners and Losers in Post-Soviet Russia*

Who are the winners and losers in Russia's transition? To some degree, income developments in Russia, with their trend towards greater inequality, have mirrored those found elsewhere in the industrial world. They appear, however, to be much more accentuated in the Russian case, since the country started the transition from an egalitarian base. As Elizabeth Brainerd summarizes the evidence: "The most striking result is the considerable widening of the overall wage distribution...wage inequality in Russia appears to have reached a level higher than that in the United States. Returns to education and occupation have increased...In addition, women's wages have declined relative to men's wages, *and older workers have suffered sharp relative wage declines (italics added)*".<sup>12</sup>

<sup>7</sup> Joel Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions," *World Politics* 50 (January 1998): 203-234, at 204.

<sup>8</sup> For an elaboration, see Michael McFaul, *Russia's 1996 Presidential Election* (Stanford, CA: Hoover Institute Press, 1997), pp. 85-88.

<sup>9</sup> Adam Przeworski, *Democracy and the Market* (New York: Cambridge University Press, 1991), p. 91.

<sup>10</sup> We note the similarity of this conceptualization with that used by Sam Peltzman in his modeling of the behavior of regulators. See Peltzman, "Toward a More General Theory of Regulation", *Journal of Law and Economics* 19 (August 1976), pp.211-240; for an empirical study that draws on this model, see Ethan B. Kapstein, *Governing the Global Economy: International Finance and the State* (Cambridge, Ma.: Harvard University Press, 1994.)

<sup>11</sup> McFaul, *Russia's 1996 Presidential Election*, p.86.

<sup>12</sup> Elizabeth Brainerd, "Winners and Losers in Russia's Economic Transition," *American Economic Review* 88 (December 1998): 1094-1116, at 1094.

In his work Milanovic has detailed the tremendous rise in inequality which occurred over such a short period of time in the early 1990s. Whereas the Russian Gini coefficient in income per capita terms was 24 between 1987-88, it doubled to 48 between 1993-95, much higher than the overall transition country average that saw growth from 24 to 33 during the same period.<sup>13</sup> The United States, in contrast, had a Gini of approximately 43 in the mid-1990s.

Along with unskilled workers, among the relative losers in the transition have been pensioners.<sup>14</sup> In 1993-94, some 26 percent of all Russians living in poverty were pensioners,<sup>15</sup> making them an over-represented group, since they make up only 19 percent of the total population.<sup>16</sup> Again, this is puzzling from a political economy standpoint, given their potential electoral weight, with some 40 percent of the voting age population.

Indeed, it is even more puzzling since the gains from transition have been so concentrated. The evidence suggests it is the more educated and highly skilled workers and managers who have been on the winning end of economic change. Brainerd reports that “the ratio of the wage of top managers to the average wage increased from 1.28 in 1991 to 1.81 in 1994. In contrast the ratio of unskilled blue-collar urban wages to the average wage fell from 0.75 in 1991 to 0.56 in 1994.”<sup>17</sup>

Commander, Tolstopiatenko and Yemtsov report similar findings. They state that among the winners “there is an unambiguous preponderance of managers and white collar workers... There is a clear positive link from educational status... to being a winner... Turning to the other side... what is very striking is the huge preponderance of pensioners... in the bottom quintile. The group risk for pensioners was over 26 percent and their share among losers was nearly four times larger than their share in the population.”<sup>18</sup> Thus, pensioners not only did poorly compared to the well-educated, but they fared worse on average than other social transfer recipients.

Part of the relative increase in managerial incomes must be due to their successful rent-seeking activity during the transition period. As Anders Aslund states “Rent seeking can be defined as any activity designed to exploit a monopoly position or to gain access to government subsidies, as opposed to profit seeking in a market with competitive firms... In the transition years 1991-93, the big money in Russia was made essentially in three means: subsidized credits, implicit export subsidies, and import subsidies.”<sup>19</sup> He

<sup>13</sup> Branko Milanovic, *Income, Inequality, and Poverty During the Transition* (Washington, DC: World Bank 1998), p. 41.

<sup>14</sup> Marco Cangiano, Carlo Cottarelli, and Luis Cubeddu, “Pension Developments and Reforms in Transition Economies,” *IMF Working Paper* WP/98/515, October 1998, p.15.

<sup>15</sup> Milanovic, *Income, Inequality and Poverty*, p. 117.

<sup>16</sup> Vladimir Mikhalev, “Social Structure in Transition: The Economic Impact on Societal Change in Eastern Europe,” (Helsinki: WIDER, 27 November 1998, processed), p. 30.

<sup>17</sup> Brainerd, “Winners and Losers,” p. 1105.

<sup>18</sup> Simon Commander, Andrei Tolstopiatenko and Ruslan Yemtsov, “Channels of Redistribution: Inequality and Poverty in the Russian Transition,” World Bank, paper prepared for the Conference on inequality and poverty in transition economies, EBRD, London, May 23-24, 1997. p. 22.

<sup>19</sup> Anders Aslund, “Social Problems and Policy in Postcommunist Russia,” in Ethan B. Kapstein and Michael Mandelbaum, eds., *Sustaining the Transition: The Social Safety Net in Postcommunist Europe* (New York: Council on Foreign Relations Press, 1997), pp. 133.

argues that “until 1994, total rents were so large that ordinary social transfers could not possibly have equalized them. It suffices to note that public expenditure on social protection amounted to 12.7 percent of GDP in 1992 compared with gross rents of 75 percent of GDP.”<sup>20</sup> Boone and Federov in a similar vein ascribe the impotence of macroeconomic policies in 1992-93 to the fact that there were too many rents and assets to redistribute (or more colloquially, too many assets to strip). Writing in 1995, that is just before the loans-for-shares swindle, they argue that as asset stripping comes to an end, vested interest will have an interest in enacting clearer rules of the games.<sup>21</sup> Although such an optimistic scenario did not come to pass, what is important for our purposes is a clear acknowledgement and realization of how important the redistribution of assets was in the early transition.

### *Russian Pension Policy*

As with many accounts of social policy in the post-communist countries, there is also a tendency among those who write on pensions to look back with nostalgia on the Soviet period. But as Walter Connor reminds us, in the Soviet Union “a poor working life was followed for the mass of the population by a poorer retirement.”<sup>22</sup> Pensions went unchanged from 1932 to 1956, even though wages rose by ten times during that period, and even during the so-called “golden years” of the Brezhnev era pensions lagged behind wage increases. As Connor reports, “This made for a considerable downside stickiness in pension levels over time. Over the 1956-81 period, the minimum wage rose by 160 percent, the minimum pension, by only 67 percent. Nor, in reality, were *average* state pensions much above the minimum... These sums by themselves left pensioners below what could be regarded—though not so named in official sources—as a ‘poverty line’...”<sup>23</sup>

Connor states that “As the Soviet Union moved toward its twilight, the burdens of and on the elderly increased... between 1960 and 1981, the pensioner population grew by 143 percent. Larger numbers no doubt contributed to state reluctance to raise pensions. Pensioners perforce turned to self-help and continued working. The USSR of the 1970s-1980s, facing another problem—chronic labor ‘shortage’-got some of the extra workers it needed by drawing on those who could not live on their pensions.”<sup>24</sup> Low regular retirement age and liberal early retirement rules for many professions also helped, since people often found “double-dipping” to be preferable than continuing work.

Post-communist Russia inherited this heavily burdened Soviet pension system, with its “contributory pension scheme with universal coverage based on PAYG (pay-as-

<sup>20</sup> Aslund, “Social Problems,” p. 137.

<sup>21</sup> Peter Boone and Boris Federov, “The Ups and Downs of Russian Economic Reform”, in Wing Thye Woo, Stephen Parker and Jeffrey D. Sachs (eds). *Economies in Transition: Comparing Asia and Eastern Europe*, The MIT Press, Cambridge, Massachusetts; London, England, 1997, pages 412.

<sup>22</sup> Walter Connor, “Social Policy under Communism,” in Kapstein and Mandelbaum, *Sustaining the Transition*, p. 32.

<sup>23</sup> Connor, “Social Policy,” p. 33.

<sup>24</sup> Connor, “Social Policy,” p. 34.

you-go) financing.”<sup>25</sup> The Soviet scheme was also characterized by tremendous variation among pension recipients, as there were all sorts of special privileges depending on where one worked (both sectorally and geographically) and for how long. Private retirement plans were nonexistent, and beyond state transfers pensioners depended upon relatives for support; oftentimes they continued to work in the informal sector, as they still do today.

The Russian pension system at present, like its Soviet predecessor, is funded through social security contributions made in the form of payroll taxes, which in periods of shortfall has been made good by budgetary allocations. It is crucial to emphasize that workers’ direct contributions to the scheme were (and are) either zero or minimal, placing the cost of the program almost entirely on the enterprise, formerly state-owned and now, as often as not, private. Naturally, this policy encouraged enterprise managers to under-report their payroll in the interest of tax evasion. In Russia, payroll taxes constituted approximately 6 percent of GDP in 1996, an even greater sum than the amount dedicated to pensions, but not all of this, of course, was dedicated to the Pension Fund.<sup>26</sup> It is largely the gap between official and actual contribution rates, coupled with other budgetary problems, that explains the current shortfall in pension outlays.

Beyond its macroeconomic problems, the Russian pension system suffers from chronic administrative headaches. As the IMF’s Marta de Castello Branco reminds us, “The system of benefits inherited from the Soviet period is highly complex, and includes several types of preferential pensions and complicated benefit formulae. The system guarantees near-universal coverage to Soviet-era workers, whether their employers have contributed or not... The initial pension benefit is typically based on previous earnings and years of service, and is often indexed according to changes in the minimum wage... Eligibility rules are broad and differentiated, with special regimes for favored occupations and other groups... The statutory retirement age is typically 60 years for men and 55 years for women... there is (also) a growing incidence of invalidity pensions and early retirement, often with higher benefits than average, drastically reducing the effective retirement age and the number of contributors.”<sup>27</sup>

The Russian pension system, like that of many other transition economies, has five major features that all point toward the need for systemic reform:<sup>28</sup>

- (1) High system dependency ratios: in Russia the number of pensioners divided by the total employed is 55 percent.
- (2) Low retirement age, as already noted.
- (3) Unfavorable demographic trends; in Russia the share of pensioners in the overall population is around 20 percent and rising .
- (4) Growing fiscal imbalances. Demographic change coupled by falling output and tax evasion and tax offsets at the enterprise level have pointed to a growing fiscal drag caused by pension expenditures, with sequestration the inevitable outcome.

<sup>25</sup> Marta de Castello Branco, “Pension Reform in the Baltics, Russia, and other Countries of the Former Soviet Union,” *IMF Working Paper* WP/98/11, February 1998, p. 8.

<sup>26</sup> De Castello Branco, “Pension Reform,” p. 11.

<sup>27</sup> De Castello Branco, “Pension Reform,” p. 13.

<sup>28</sup> Drawn from Cangiano, et.al., “Pension Developments,” pp. 18-21.

- (5) High contribution rates and weak compliance.
- (6) Significant intragenerational and intergenerational inequalities.

Despite these developments, pension expenditure as a percentage of government expenditure has actually held reasonably steady during the transition period, falling ever so slightly from 14.8 to 14.6 percent. As a percentage of GDP, however, the drop has been steeper; from 6.9 percent in 1992 to 4.5 percent in 1996.<sup>29</sup> This development is explained by two interrelated fiscal phenomena: budget sequestration—the failure of the Russian state to meet its obligations—and declining benefits due to incomplete indexation. As of late 1998, Russian pension arrears totaled some 30.5 billion rubles.<sup>30</sup>

As with other transition economies, the Russian government has been preparing a major reform of its pension system, which would rest on a “multipillar” approach combining PAYG and fully funded (FF) systems through direct worker contributions to a retirement account. With World Bank assistance, Russia is now planning its own pension reform program, but the scheme is not well advanced. The plan as presently conceptualized “has four major elements: (i) a reduction in the size of the pay-as-you-go system and its conversion into a system based on notional defined contribution principles, (ii) a phasing out of the current system of pension privileges to be replaced by a system of funded, supplemental occupational pensions, (iii) phasing in of a universal second pillar system of funded individual accounts, and (iv) creation of a framework for voluntary supplementation on either an individual or group basis.”<sup>31</sup>

In sum, Russian pensioners have never been relative beneficiaries of state largesse. But at least during the Soviet era they received with regularity the meager sum that they were due. Today, with the collapse of Russian state finances, even those small amounts are not assured. Pensioners were certainly not winners under Communism, but the transition has been even less than kind to them. Apparently, the government has had higher priorities than meeting its obligations to the aged, no matter their electoral weight. And of those priorities, few were more important than the privatization of Russian state enterprises.

### *Privatizing Russia*

Writing in 1993, Maxim Boycko, Andrei Shleifer, and Robert Vishny could proclaim that “privatization has become the most successful reform in Russia.”<sup>32</sup> The reasons for their optimism were not difficult to see. Starting in 1991, with a completely state-owned enterprise structure and no privatization program to speak of, the Russian government had, by 1993, removed over half of its firms from its books, and by the year’s end over 20 percent of the workforce was employed by such companies (the laggards were large-scale and “strategic”—e.g. defense—enterprises, that of course had more employees).

<sup>29</sup> De Castello Branco, “Pension Reform,” p. 21.

<sup>30</sup> World Bank, *Russian Federation Pension Reform: Implementation Project*, 15 October 1998.

<sup>31</sup> World Bank, *Russian Federation Pension Reform*.

<sup>32</sup> Maxim Boycko, Andrei Shleifer, and Robert Vishny, “Privatizing Russia,” *BPEA* 2 (1993): 139-192, at 139.

For our purposes it is critical to emphasize that western analysts have tended to contrast Russia's privatization "success" with Poland's failure to achieve similar results. As Andrei Shleifer and Daniel Treisman have written, "...in privatization Russia moved far ahead of Poland. In mid-1994, as Moscow wrapped up its mass voucher privatization, Warsaw had barely started its own."<sup>33</sup> As already noted, it may well be that, from a social welfare perspective, it is Warsaw that had good reason to delay its own privatization scheme.

The success achieved in the speed of privatization is even more remarkable when contrasted with Russia's starting position. During the Soviet era, of course, the state owned and managed almost all the means of production. With the advent of General Secretary Mikhail Gorbachev's "perestroika" program in the late 1980s, a law was introduced permitting the creation of "cooperatives" and as a result a fairly significant number of entrepreneurial activities, especially restaurants, were launched. By 1990, perhaps 10 percent of the Russian workforce was employed by non-state enterprises of one kind or another.<sup>34</sup>

Gorbachev's reforms had another dimension that was of great long-run significance: it was associated with a substantial decentralization of authority away from the Moscow-based planning ministries. According to Ira Lieberman and Suhail Rahuja of the World Bank, "Gorbachev's reforms transferred power from planners to workers, managers, and regional authorities. What was not anticipated was the manner in which these groups began to exploit their new-found freedoms. State enterprises began rapidly increasing workers' wages, bonuses, and welfare expenditures. This led to a sharp decline in after-tax profits remitted to the state and a federal budget crisis."<sup>35</sup>

When Russia launched its privatization program in 1992 it is certain that many groups were opposed, but the data on public opinion is contradictory. Whereas Boycko, Shleifer, and Vishny state that "60 percent of the Russian people supported privatization," Shleifer and Treisman have since reported that "privatization prospered despite widespread popular antipathy."<sup>36</sup> What is clear is that during the transition period Anatoly Chubais, the father of Russian privatization and chairman of the State Property Committee (GKI), went from being among the most revered to among the most despised of political leaders.

At the outset the Russians contemplated three alternative methods for privatizing state enterprises: "First, some shares should be given away for free to workers at the enterprise that was being privatized. Second, all citizens or adults should receive some share of state property for free. Third, property should mainly be sold, not given away for free."<sup>37</sup>

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<sup>33</sup> Andrei Shleifer and Daniel Treisman, "The Economics and Politics of Transition to an Open Market Economy," OECD Development Center Working Paper, 1997, p. 55.

<sup>34</sup> Anders Aslund, *How Russia Became a Market Economy* (Washington, DC: Brookings Institution, 1995), p. 224.

<sup>35</sup> Ira Lieberman and Suhail Rahuja, "An Overview of Privatization in Russia," in Ira Lieberman and John Nellis, eds., *Russia: Creating Private Enterprises and Efficient Markets* (Washington, DC: World Bank, 1994), p. 9.

<sup>36</sup> Boycko et al., "Privatizing Russia," p. 139; Shleifer and Treisman, "Economics and Politics," p. 55.

<sup>37</sup> Aslund, *How Russia Became a Market Economy*, p. 226.

In practice, however, the program “was heavily influence by the differences between the Yeltsin presidency and the Russian parliament.”<sup>38</sup> According to Shleifer and Treisman, “the industrial lobby raised fierce opposition in parliament and threats to reverse privatization arose repeatedly throughout its implementation.”<sup>39</sup> This group, which had won considerable freedom to run their enterprises (often into the ground) during the Gorbachev era, was not about to lose control to outside owners now, and especially to foreign investors. This opposition would not only result in important amendments to the privatization program and its implementation, but it would ultimately determine the pattern of winners and losers associated with this reform. In the words of Andrei Shleifer, principal Western adviser to Russian government in the period of early privatization, and Dmitry Vasiliev, a key official in the Privatization Ministry, “[Russian ownership] structures have been to a large extent determined by the political imperative of accommodating managerial preferences in the privatization program since without manager support firms would have remained under political control.”<sup>40</sup>

By the time that the Russian privatization program was launched in 1992, industrial managers had already profited enormously from their newfound freedoms. As Michael McFaul recounts, “Empowered with increasing control over their enterprises, directors could also supplement their individual wealth by hiding profits or skimming extra production. An extensive gray economy provided tremendous incentives for opportunistic behavior. Moreover, the forces inhibiting... corruption... did not exist.”<sup>41</sup>

Nor did workers offset the malign behavior of their managers. The problem is that Russian enterprises were really complete communities that provided their employees with medical care, apartments, leisure facilities, schools, and even hot meals at lunch. Workers were thus completely dependent on enterprise directors not only for their employment, but also for obtaining the subsidies that kept these services at nominal cost. As McFaul rightly says, “directors were looked upon as providers to workers for everything.”<sup>42</sup>

It was this total control over people and resources that Soviet-era managers tenaciously held onto in the face of the newly proposed Russian privatization scheme. As it evolved, the scheme envisioned three paths to privatization: *Option 1*, in which managers and workers were given 25 percent of the enterprise’s equity in preferred, nonvoting shares, with the option to obtain another 10 percent of voting, equity shares on favorable terms; in addition, managers had a further option to obtain another 5 percent of voting equity at book value; *Option 2*, in which employees could buy 51 percent of the ordinary shares for 1.7 times book value; and *Option 3*, limited to large enterprises, under which managers would be permitted to run the enterprise under contract with the local

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<sup>38</sup> Lieberman and Rahuja, “An Overview,” p. 9.

<sup>39</sup> Shleifer and Treisman, “Economics and Politics,” p. 55.

<sup>40</sup> Quoted from Bernard Black, Reinier Kraakman and Anna Tarassova, “Russian privatization and corporate governance: what went wrong”, Stanford Law School, John M. Olin Program in Law and Economics, Working Paper No. 178, September 1999, p. 15.

<sup>41</sup> Michael McFaul, “Agency Problems in the Privatization of Large Enterprises in Russia,” in Michael McFaul and Tova Perlmutter, eds., *Privatization, Conversion, and Enterprise Reform in Russia* (Stanford University Center for International Security and Arms Control, May 1994), p. 42.

<sup>42</sup> McFaul, “Agency Problems,” p. 43.



privatization agency, over time winning the right to acquire 20 percent of the voting capital of the enterprise.<sup>43</sup>

In practice, it was *Option 2* that was the preferred route to privatization. According to McFaul, “Of the 46,815 enterprises that had been privatized by the end of 1992, 63.7 percent had chosen Option 2, while only 34.5 percent had chosen Option 1, the original privatization design. In 1993, more than 75 percent of all enterprises were privatized according to Option 2.”<sup>44</sup> The reasons for this are not hard to find, as “The provisions of Option 2 are extremely effective in serving the interests of directors. They prevent outside investors from gaining majority ownership in enterprises, while putting shares the managers themselves don’t buy into the hands of workers who are highly susceptible to their influence.”<sup>45</sup> In short, Soviet-era directors captured the Russian privatization program.

For his part, Aslund asserts that the gains from this capture have been exaggerated. He writes that “Contrary to the popular perception, managers’ revenues from the large-scale voucher privatization were quite limited... In April 1996, the total value of 17,000 privatized large and medium-sized enterprises was assessed at some \$28 billion, or 7 percent of GDP... We know from World Bank enterprise surveys that enterprise managers initially received 8 percent of the stocks and that this share later rose to 20 percent. Hence, managers have gotten some 1.4 percent of the GDP through the voucher privatization...”<sup>46</sup> These figures are based on the official estimates of stock values. These, as we know, are wide off the mark, because assets were heavily and consistently undervalued.<sup>47</sup> Still, even if Aslund’s figures are correct, this amounts to a virtual give-away of some \$5.6 billion, and the more likely number is probably some ten times greater. To this one needs to add the rents given to bankers by virtue of the subsidized credits they received from the state. Further, to the extent that state enterprises have run significant tax and payment arrears, and continued to receive subsidies if only for their “social assets,” the number is a multiple of the Aslund estimate. In the next section we will see that, far from being trivial, these numbers are consequential from the perspective of the Russian budget and its fiscal stance.

### *The Vital Link: Taxes, Subsidies and Pensions*

As noted above, one of the major purposes of privatization schemes around the world has been to reduce the public sector borrowing requirement (PSBR). Given

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<sup>43</sup> The scheme is well described in Lieberman and Rahuja, “An Overview,” pp. 13-17.

<sup>44</sup> Aleksander Bim reports similar results. In his sample of privatized enterprises, 83 percent chose the second option. See A. Bim, “Ownership and Control of Russian Enterprises and Strategies of Stockholders”, *Communist Economies and Economic Transformation*, No.4 (December), vol. 8, pp. 471-500.

<sup>45</sup> McFaul, “Agency Problems,” p. 44.

<sup>46</sup> Aslund, “Social Problems,” p. 134.

<sup>47</sup> According to Black, Kraakman, and Tarassova, many privatized assets were underestimated by a factor of 10 and above, running even into hundreds. See Bernard Black, Reinier Kraakman and Anna Tarassova, “Russian privatization and corporate governance: what went wrong”, Stanford Law School, John M. Olin Program in Law and Economics; Working Paper No. 178, September 1999 (also on Social Science Research Network website: <http://papers.ssrn.com>.)

external constraints on domestic deficit financing, public sector borrowing either raises interest rates and “crowds out” the private sector, or it leads to inflation as the government prints money to cover its obligations. Removing state enterprises from the books through privatization can lead both to a one-shot revenue boost and to a continuing stream of tax payments, making this policy attractive in the face of systemic pressures to reduce fiscal deficits.

William Buitter notes that “governments can collect revenues from privatization in two ways. First, they can raise revenues by selling the ownership claims to the state enterprises. Second, they can tax the privatized enterprises after privatization.”<sup>48</sup> It should be noted that, in transition economies like Russia, removing an enterprise from the government’s books will, in principle, also lead to a reduction in spending for the ancillary “social assets” of the enterprise, including its housing, schools, hospitals, and so forth.

At the same time, there may be a revenue loss over some relevant time horizon. As Buitter suggests, “Privatization of state enterprises reduces the information base available to the tax authorities and weakens or eliminates its traditional administrative apparatus for collecting the taxes.”<sup>49</sup> It may also lead to a burden-shifting exercise in which central or regional governments have to cover the expenses associated with the firm’s social expenditures. We will argue that Russian authorities got the worst of both worlds with their privatization scheme: they lost their tax base, but continued to subsidize the firms and social assets anyway. In 1992 these subsidies amounted to some \$55 billion, falling to \$20 billion in 1993; as subsidies fell, however, tax arrears mounted.<sup>50</sup>

These comments serve to remind us that privatization and fiscal reform are, at least in principle, intimately connected. But in order to forge that link, governments must adopt a hard budget constraint with respect to these enterprises, denying the subsidized credits and monopolistic markets that they may have enjoyed as state-owned firms. As Havrylyshyn and McGettigan write: “Without hard budget constraints, enterprises have little incentive to become efficient.” And it appears that the major subsidy to the firms has come in the form of lax tax administration. “Indeed...tax arrears are now one of the most important routes by which budget constraints are softened across a variety of transition countries. The magnitudes are substantial if measured as stocks, ranging...to as much as 12 percent of GDP (in) Russia.”<sup>51</sup>

It is crucial to emphasize that Russian tax and fiscal policy are now trapped in what must be described as a vicious circle. The state’s failure to collect taxes and willingness to turn a blind eye to tax evasion has led to a fiscal crisis, which in turn has been met by the government’s failure to meet its obligations to transfer recipients through sequestration and payment defaults. But the state’s failure to meet its own obligations

<sup>48</sup> William Buitter, “Aspects of Fiscal Performance in Some Transition Economies Under Fund-Supported Programs,” *IMF Working Paper 97/31*, April 1997, p. 39.

<sup>49</sup> Buitter, “Aspects of Fiscal Performance,” p. 39.

<sup>50</sup> See Liam Halligan, Pavel Tplukhin and Dirk Willer, “Subsidisation of the Russian Economy,” Russian European Center for Economic Policy, Moscow, November 1995, p. 8.

<sup>51</sup> Oleh Havrylyshyn and Donal McGettigan, “Privatization in Transition Countries: A Sampling of the Literature,” *IMF Working Paper 99/6*, January 1999, p. 31.

causes other actors to question why they should meet theirs; a culture of corruption is thus generalized throughout the system. What does it mean to abide by the law if the government has no respect for its own commitments? In this respect, Buitter asserts that the International Monetary Fund should also bear some responsibility for its attitude towards sequestration. He writes that "Such current arrears should be viewed as seriously as arrears on the internal and external debt of the government, as they too represent the moral (and sometimes the legal) equivalent of a breach of contract... The Fund has... taken too relaxed a view of sequestration and current arrears in the past..."<sup>52</sup> Former World Bank Chief economist, Joseph Stiglitz carries it a step further: reneging on social payments was not only tantamount to breaking an implicit social contract, it helped destroy social capital that is crucial for economic development. He writes: "Breaking what is widely viewed as part of social contract—such as not paying the elderly pensions which they believe they have earned—undermined social capital, especially if at the same time the govt is transferring vast amounts of wealth to a few individuals."<sup>53</sup>

For lack of a better word, the Russian tax system is a mess. Aslund calls it "an inconsistent patchwork" which has gotten "worse over time." It is characterized by multiple taxes imposed by various jurisdictions that amount, if paid in full, to confiscatory levels, and as a result it has led to corruption, evasion, and a series of exemptions.<sup>54</sup> This, in turn, has made taxation a primary arena for rent-seeking and to distorted resource allocation. This failure of tax policy has led Buitter to conclude that "no structural reform measure (such as trade reform or privatization) should ever be implemented without considering its implications for public revenues and expenditures."<sup>55</sup>

Russia's tattered tax system is not simply the manifestation of a "crippled state."<sup>56</sup> In many cases, the accumulation of tax arrears by state and privatized enterprises instead represents "an implicit bargain between the central government" and particular sectors, especially energy. In this specific example, the government has turned a blind eye to the energy sector's tax arrears so long as it continues to supply non-paying customers. Indeed, of the ten largest tax debtors to the federal budget in 1995, eight were in the energy sector (the other two were automotive). The net effects of this transaction have not, however, been neutral; to the contrary, the reported profits of the energy sector increased along with their tax arrears, once again suggesting that rent-seeking is good business.<sup>57</sup>

It is in the presence of this fiscal shortfall that pension reform has loomed so large from a macroeconomic perspective; as the IMF states "The reform of public pension systems is a key component of social spending reform in countries in transition. Pension systems in transition countries have come under increasing pressures as the transformation process has led to an increase in the ratio of pensioners to contributors and

<sup>52</sup> Buitter, "Aspects of Fiscal Performance," p. 40.

<sup>53</sup> Joseph Stiglitz, "Quis Custodiet Ipsos Custodes: Corporate Governance Failures in the Transition", Annual World Bank Conference on Development Economics, Paris June 21-23, 1999, p.21.

<sup>54</sup> Aslund, *How Russia Became a Market Economy*, p. 204.

<sup>55</sup> Buitter, "Aspects of Fiscal Performance," p. 44.

<sup>56</sup> See Susan Himes and Martine Millet-Einbinder, "Russia's Tax Reform," *OECD Observer*, January 1999.

<sup>57</sup> Shleifer and Triesman, "Economics and Politics," p.46.

has reduced tax compliance...*With the declining number of contributors and weakening tax compliance putting downward pressure on revenues, most countries initially responded by reducing the generosity of benefits... (italics added)*”<sup>58</sup> Indeed, efforts by the late Gorbachev regime to raise taxes to meet pension fund obligations in 1990-91 were a catalyst for the Soviet Union’s final budgetary chaos, as it forced economic activity underground and helped fuel the tidal wave of tax evasion that still engulfs Russian society.

What this fiscal story suggests is that the Russian central budget and tax policy has been largely captured by managerial interests, which through direct subsidies and tax arrears greatly improved their economic position, at the expense of pensioners and others who depended on state transfers of social assistance. Yet this presents a puzzle, for if pensioners are so numerous, why were elected officials not more responsive to them? We address that puzzle in the following section.

### *Russian Electoral Politics*

Up to this point we have demonstrated that Russia pursued an economic strategy that maximized rent-seeking opportunities for the managerial class while minimizing official flows to transfer recipients. The outcome has been a widening of income inequality with a concentration of income that is greater than that found in the United States. If Russia had the efficient capital markets—including human capital markets—to facilitate social mobility, these outcomes might be deemed acceptable from a normative standpoint, winning the approval of voters who, at least, could then perceive a brighter future for their children.

Yet Russia’s transition has been politically contested, and sharply so, if only in an unorganized way (a fact that has been crucial to electoral outcomes). Between 1992 and 1995, the percentage of Russians polled who had a negative view of the market economy rose from 7 percent to 44 percent.<sup>59</sup> This is consistent with a poll taken in December 1996, some five years after the transition had been launched, in which 43 percent of Russians said “they would like the Communists to govern our country.”<sup>60</sup> And as these words are being written in April 1999, pollsters find that Russian president “Yeltsin’s popularity...is falling rapidly...only 6 percent of those questioned approve of the head of state’s work, while 92 percent do not approve of it.”<sup>61</sup> It can be inferred that these views are highly correlated with the country’s economic performance.

Sharp divisions have thus arisen within the Russian electorate since the outset of transition. In analyzing the subsequent patterns of voting behavior, Michael McFaul has found that “geographic and demographic voting patterns...clearly delineate the contours of...polarization within Russia’s electorate. First, geographically, the urban-rural divide demarcates the main line of division between those supporting the status quo and those

<sup>58</sup> IMF, *World Economic Outlook: May 1998*, pp. 114-116.

<sup>59</sup> Anders Aslund, Peter Boone, and Simon Johnson, “How to Stabilize: Lessons from Post-Communist Countries,” *BPEA* 1: 1996, p. 274.

<sup>60</sup> *Izvestia*, “Poll: 43% of Russians Would like the Communists to Return to Power,” 7 December 1996, p. 1.

<sup>61</sup> BBC, “Yeltsin’s Popularity Slumps to New Low,” 2 April 1999.

who do not. People living in big cities...have tended to support anticommunist candidates, whereas people in rural areas have tended to support communist candidates. *Age has been a second cleavage dividing supporters and opponents of change. Russia's oldest voters have been more resistant to Yeltsin's reforms, whereas Russia's youngest voters have enthusiastically supported reform. Third...supporters of reform have tended to be much richer than opponents of reform (italics added).*"<sup>62</sup> We might note in this context that most of Russia's elderly live in rural areas.

At one level these voting patterns seem intuitive. We can imagine that older voters are more conservative than their children and thus have a greater likelihood of supporting the party that makes greater promises of bringing about a return of the "good old days." On the other, it seems strange that a politician, seeking re-election, would forego the votes of the single largest bloc of voters—pensioners. Further, we know that pensioners participated much more actively in elections than other groups.<sup>63</sup>

It appears that Yeltsin crafted the following electoral strategy in 1996: win the support of the elite, who would bankroll the election with which Yeltsin could buy votes from urban winners (mostly managers and the new entrepreneurial class) and former state sector workers. It was, in effect, a strategy that—we think consciously—was followed from January 1992 onward. According to McFaul, "estimates of spending by the Yeltsin campaign ranged from \$100 million to \$500 million," or a large multiple of what his opponent, the Communist Gennadii Zyuganov, could muster.<sup>64</sup> On the campaign trail, "Yeltsin promised increased spending in dozens of sectors and regions...In every city that he visited during the campaign—twenty-five in all—he made some kind of new commitment." Zyuganov, in contrast, "promised greater state support for the economically disadvantaged," including peasants and pensioners.<sup>65</sup>

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<sup>62</sup> Michael McFaul, *Russia's 1996 Presidential Election* (Stanford, CA: Hoover Institution Press, 1997), p.8.

<sup>63</sup> We thank Evelyn Davidheiser of the University of Minnesota for emphasizing this point.

<sup>64</sup> McFaul, *Russia's 1996 Presidential Election*, p. 13.

<sup>65</sup> McFaul, *Russia's 1996 Presidential Election*, pp. 33, 42.

#### 4. *Did the strategy work: Who voted for Yeltsin?*

The argument made above was that the choice of privatization strategy and the outcome in terms of income of different population groups were endogenous: a product of Yeltsin's government vote-maximizing strategy. We shall try to examine empirically this hypothesis by using the results of VCIOM (All-Russian Center for Public Opinion Research) surveys.<sup>66</sup> The surveys ask a number of questions that can be broadly divided into three categories: economic variables (income, possession of household durables, level of subjective poverty line etc.), social or sociological variables (job position, type of employment, enterprise type etc.), and political or attitudinal (views toward the reform process, voting preferences and actual voting decisions). Two VCIOM surveys, conducted respectively in July and September 1996, give the data on people's voting behavior during the second round of presidential elections in June 1996.

We examine two parts of our hypothesis. First, using the repeated VCIOM cross-sections that cover the period from March 1993 to September 1996 we look at the evolution, in terms of income and social status, of several key socio-economic groups: workers (full-time job holders), people engaged in entrepreneurial activities and businessmen, the self-employed (including individual farmers), pensioners and the unemployed<sup>67</sup> Second, we look at the electoral behavior of different socio-economic groups, and try to explain their electoral choices by different household and individual characteristics.

##### *What happened to incomes and status of different social groups?*

Figure 1 shows the change in real per capita income of the five key socio-economic groups.<sup>68</sup> The five groups account for about 85 percent of all households: 54 percent of households are full-time workers, 21 percent are headed by the pensioners, 5.7 percent are headed by the unemployed, while the two other groups (entrepreneurs/businessmen and the self-employed) are smaller, representing respectively 4½ and 1.2 percent of all households. The order by level of income is as expected: entrepreneurs are throughout the richest group, followed by the self-employed, and then workers, pensioners and the unemployed. Incomes of entrepreneurs and the self-employed are more variable, and they too show a slight downward trend (in real terms).

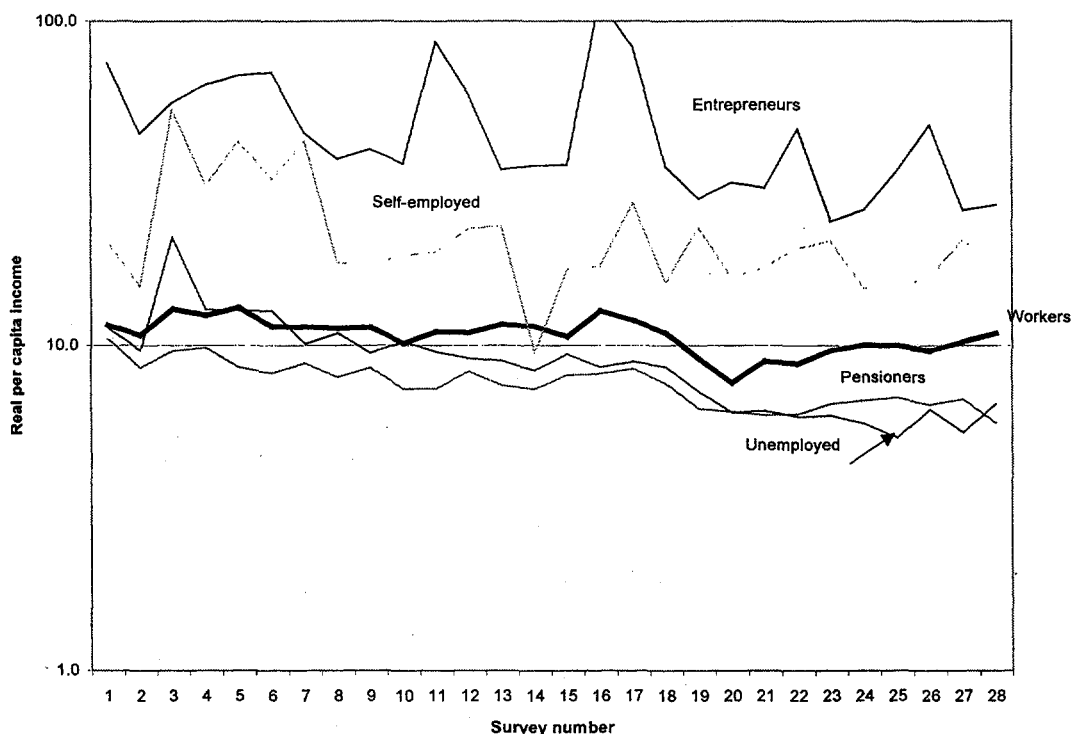
<sup>66</sup> We use the twenty-nine cross-sectional data sets covering the period from March 1993 to September 1996. The survey is a representative sample of Russian households conducted monthly (between March 1993 and January 1994) and approximately every second month since. The original data set consisted of 91,090 observations spread over 29 cross sections. The number of observations was reduced to 80,826 after omitting the observations that did not contain information on family income (total or by components). The individual cross sections contained between 3,626 (January 1994) and 2,034 (September 1996) observations. Although the reduction of the sample size over time was considerable it did not, according to the VCIOM staff, affect the representativity of the sample.

<sup>67</sup> The questionnaire includes, in addition, servicemen, students, and house-keepers. We are not interested in the changes in the position of these groups.

<sup>68</sup> Household head determines to which group the whole household belongs. Household income variable was constricted from the data given in VCIOM. For the details see Branko Milanovic and Branko Jovanovic, "Change in the perception of the poverty line during the times of depression: Russia 1993-96", *World Bank Economic Review*, September 1999.

Workers' income is the steadiest—with the difference between the initial 1993 income (calculated as the average of income over the first three surveys) and the end-period income (the average of the three last survey) being only minus 13 percent. Pensioners have, in the meantime, lost 1/3 of their real per capita income, and the unemployed 60 percent.

Figure 1. Real per capita household income of five socio-economic groups ('000 rubles, in logs, at March 1993 prices)

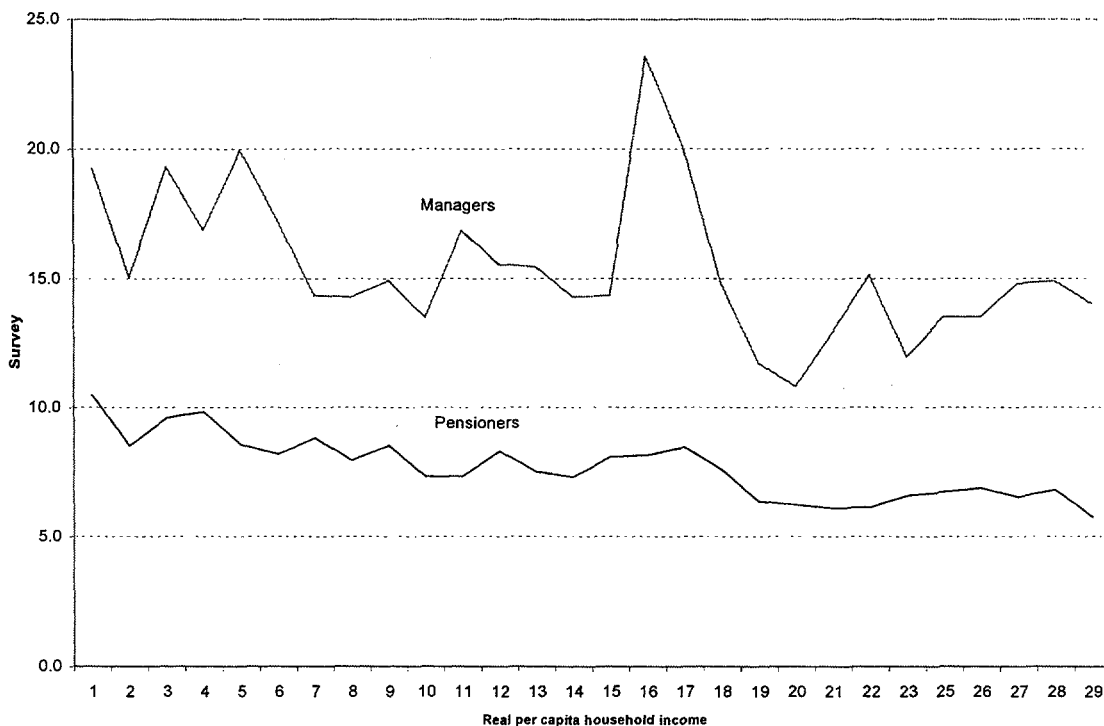


In terms of our hypothesis, though, the key is the relationship between the main presumed beneficiaries of the privatization—enterprise managers—and transfer-recipients (mostly pensioners). The socio-economic classification is satisfactory for pensioners, but the category of workers is too broad for our purposes, since many of them did not benefit much or at all from privatization. Fortunately, VCIOM also has a different variable “job position” which ranks all working individuals into ten groups, starting from top managers, heads of divisions, and professionals and ending with unskilled agricultural laborers. We consider the first three “ladders” (top managers, heads of divisions, and professionals) to be the main presumed beneficiaries of privatization and reforms. Figure 2 then contrast their (managers’) households’ real per capita income with those of pensioners.<sup>69</sup> The ratio between managers’ and pensioner’s income increased from 1.8 in the early 1993 to almost 2.5 at the end of 1996. We conclude that the

<sup>69</sup> The use of per capita adjustment is biased in favor of pensioners’ households since they are smaller (average size of pensioner households is 2.2 vs. 3.2 for managers’ households) and older. If we were to use equivalent scale adjustment which implies that large households and children are treated as less than adults, managers’ income would increase by more than pensioners’.

relationship between the incomes of managers and transfers recipients (pensioners and even more so the unemployed) has increased between 1993 and 1996.

Figure 2. Real per capita income of managers' and pensioners' households ('000 rubles at March 1993 prices)



In addition to income, subjectively perceived change in status is also important. In the VCIOM surveys, respondents—generally household heads—have been asked<sup>70</sup> to place their current and past (two years prior) social status on an ordinal scale going from 1 to 10. On average, over 40 percent of respondents place themselves in the three median ladders (fourth to sixth). There is also, on average, a decline in the perceived status by about 0.7 points (ladders) over the entire period. The negative values—status declines—carry over throughout all the surveys ranging from relatively low mean declines of 0.3 (in the second half of 1995) to the very steep mean declines of over 1 ladder point (in the first quarter of 1996). The subjective status change variable is very important because it is the only variable in the VCIOM data set that has a certain longitudinal characteristic. A person compares his/her current and past status: it therefore reflects a person's feeling as to whether he/she was a (relative) loser or winner during this period. This is not the case with income where (although we know the current person's income) we do not know what his income was two years earlier.<sup>71</sup>

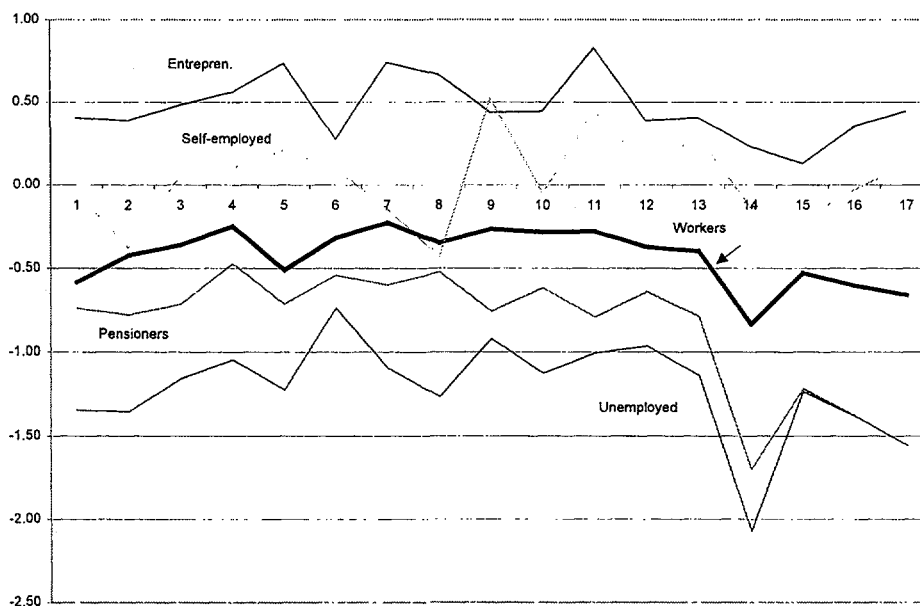
<sup>70</sup> This question appears for the first time in survey no. 13 (second quarter of 1994). Its series is therefore shorter than the series for income.

<sup>71</sup> Clearly, as we illustrated in the previous paragraphs, we know how the mean income of different social groups changed, and whether they gained or lost, but we do not know how incomes of specific individuals behaved.



Figure 3 shows the perceived change in social status by socio-economic group. The results are similar to those obtained by looking at real income. Entrepreneurs show consistently the highest, and the only consistently positive, status gain. The self-employed show very little net change in social status and workers show a loss by about 0.5 ladder points. The unemployed show, predictably, the largest status loss. Pensioners are between workers and the unemployed, but beginning from approximately September 1995, their self-assessment tracks rather closely the very negative status self-assessment of the unemployed. Pensioners and the unemployed display both in terms of real income and status assessment strong similarities.

Figure 3. Subjective assessment of one's change in the status position over the last year prior to each survey (on a ten ladder-level scale)



### *From incomes and status to votes*

How did these changes in real income and subjective position translate in votes at the election time? The second round of the June 1996 presidential election was contested by the two top candidates from the first round.<sup>72</sup> They were Yeltsin, who obviously was the candidate of continuity, and Zyuganov, a Communist party candidate, equally obviously a candidate of discontinuity. Tables 1 and 2 show the percentage of pro-Yeltsin vote and the average household per capita income by socio-economic group and job

<sup>72</sup> The second round of the vote took place on July 3, 1996. The vote thus occurred between the VCIOM May and July surveys. In the July and September surveys, respondents were asked for whom they voted in the second round. Since VCIOM surveys are retrospective for income (people are supposed to give their income over the last month), we use the actual values from the two surveys as indicators of person's income, status change, household characteristics etc. at the time of vote (i.e. early July). Note that since the surveys are not panels, it is impossible to relate the vote that a person reports in September to have made in July to his/her actual June or July income.

type.<sup>73</sup> The two tables are arranged so that the percentage of the pro-Yeltsin vote decreases as one moves down the column. What is remarkable is that income level too—with one or two exception—decreases as we move down the column. The correlation between pro-Yeltsin vote and income level is indeed very strong: it is 0.81 for socioeconomic groups, and 0.84 for job type.<sup>74</sup> For example, in Table 1, we see that more than 93 percent of entrepreneurs and businessmen voted for Yeltsin (that is, less than 7 percent voted for Zyuganov), and, of course, they had an average income that is more than twice the mean Russian income. The second highest percentage of the pro-Yeltsin vote was among the self-employed (82 percent) while their income was 50 percent above the Russia mean. Pensioners show a distinct lack of support for Yeltsin: about the same number of pensioners voted for him as for Zyuganov; and their per capita income was lower than income of any other social group except the unemployed. The same regularity holds if we look at job types (Table 2). Almost 91 percent of top managers voted for Yeltsin, and only 43 percent of peasants. But the ratio between their mean per capita incomes was almost 5 ½ to 1.

Table 1. Percentage of pro-Yeltsin vote in 1996 and household per capita income (by socio-economic group)

Socio-economic group	Percentage of pro-Yeltsin vote	Household per capita income at the time of election ('000 rubles at March 1993 prices)
Entrepreneurs/businessmen	93.2	26.6
Self-employed	81.6	19.8
Part-time workers	77.0	12.3
Housekeepers	74.5	5.9
Full-time workers	70.6	10.6
Unemployed	68.9	5.4
Students	57.0	7.1
Pensioners	51.5	6.7
Total	67.7	12.8

<sup>73</sup> The VCIOM survey results show a Yeltsin 2-1 edge over Zyuganov. The actual second round voting outcome was less overwhelming: Yeltsin won 53 to 40 (edge 1.32-1).

<sup>74</sup> There are very few departure from this "rule". Among socio-economic groups, students and the unemployed support Yeltsin more than we would expect, based on their average income alone.

Table 2. Percentage of pro-Yeltsin vote in 1996 and household per capita income (by job type)

	Percentage of pro-Yeltsin vote	Household per capita income at the time of vote ('000 rubles at March 1993 prices)
Top managers	90.9	27.3
Heads of divisions	82.3	16.3
Professionals	77.6	12.3
Clerical employees	73.3	9.5
Skilled workers	66.5	10.0
Unskilled workers	67.7	8.4
Agricultural skilled workers	47.0	7.0
Peasants	42.9	5.0
Total	73.1	11.8

These tabulations are useful because they give us some initial insight into the voting patterns. However, a better test of the hypothesis is to run a regression where the decision to vote for Yeltsin is explained by a set of economic and personal characteristics. Our hypothesis is that people whose status has improved, and whose income has increased (either in real terms or compared to the rest of the population) will be more likely to vote for Yeltsin—even after controlling for other relevant characteristics like education or age. From the analysis so far, we know that social groups whose status and relative income have improved are entrepreneurs and (to a lesser extent) the self-employed, and among the job types, top managers, heads of the divisions, and professionals. At the other end of the spectrum are transfer-recipients—pensioners and the unemployed—who have significantly lost in terms of status, and whose income is both low, and has decreased compared to the income of managers and entrepreneurs.

Table 3 shows the results of several probit regressions where the dependant variable takes the value of 1 if person voted for Yeltsin, and 0 if he voted for Zyuganov.<sup>75</sup> The coefficients show change in probability of pro-Yeltsin vote in case of an infinitesimal increase in independent variable (estimated at its mean); when the RHS variable is a dummy variable, the change in probability is for a discrete change in the dummy variable from 0 to 1.

In regression 1, we have on the RHS only income, change in status, expected change in status and socio-economic group. Expected change in status is a new variable. It is similar to the change in status, expect that, instead of being retrospective (“how did you status change compared to two years ago”), it is prospective: it asks respondents how they expect their status to change within the next five years. The ten-point ladder scale is

<sup>75</sup> Non-votes or invalid votes are treated as missing values.

the same. Clearly, the positive value denotes expectation of improvement in status.<sup>76</sup> We see that income and both status variables are highly significant. One ladder-point improvement in status, and one-ladder point expected improvement in status increase probability of the pro-Yeltsin vote by 2.5 and 3.9 percent respectively. Compared to a full-time worker, entrepreneurs are more likely to vote for Yeltsin, while students and pensioners are less. The other social groups do not differ significantly from full-time workers.

In regression 2, we introduce job position too. The most important change is that job position substitutes to a large extent for socio-economic group. No coefficient for a socio-economic group, except for entrepreneurs, is highly significant any more, while the three top job types (top managers, heads of division, and professionals) are, controlled for other variables, more likely to vote for Yeltsin. On the other hand, agricultural workers (both skilled and unskilled) are less likely to vote for Yeltsin. For example, a change from a skilled industrial to a skilled agricultural worker reduces—everything else being the same—probability of a pro-Yeltsin vote by 13.4 percent. Income as well as both status variables remain statistically highly significant.

Then, in regression 3 we add age, sex and education variables.<sup>77</sup> They swamp the importance of both socio-economic group and job position with the exception of agricultural workers who still remain significantly anti-Yeltsin, and entrepreneurs who remain pro-Yeltsin. But the voting decision are now explained by income, the two status variables, and age (pro-Yeltsin vote decreases with age), sex (women are 7 percent more likely to vote for Yeltsin than men), and university education (between 13 and 17 percent more likely to vote for Yeltsin than people with technical college). Finally, in regression 4, we add the size of settlement variables ranging from rural areas to Moscow. No significant difference appears except for Moscow which is more pro-Yeltsin than the rest of the country.<sup>78</sup>

We can conclude that the decision to vote for Yeltsin is *not* explained—with the exception of entrepreneurs and agricultural workers—by a person's belonging to a given social group or having a given job position *per se*. Instead, it is explained by four of five general variables: person's level of income, past change in status, expected change in status, age, sex, and, only to some extent, by education, and residence in Moscow. Muscovites and those with completed university education were about 10 percent more likely to vote for Yeltsin (everything else being the same). But any other education level or residence had no effect on voting behavior. This also disproves the widely held view that rural residents *per se* were anti-Yeltsin: if they were it was because of other variables (low education or low income, or negative expectations about the future) not because they happened to live in the countryside.

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<sup>76</sup> Interestingly, while past change in status is overall negative, the expected change in status is overall positive (+0.2 status points). People were, on average, optimistic. All social groups, except pensioners, expected, on average, an improvement in status. The correlation between past change in status and expected change in status is practically zero (-0.02) which makes both variables particularly suitable to serve as controls in our regressions.

<sup>77</sup> All three refer to household head.

<sup>78</sup> However, and very interestingly, interacting Moscow and university education, show that Moscow-based university educated were *less* likely to vote for Yeltsin. The coefficient is relatively large (-15 percent) and is significant at 5.3% level.

Table 3. Determinants of probability of pro-Yeltsin vote  
(probit estimates; z scores in parentheses)

	Equation (1)	(2)=(1) with job types	(3)=(2) with education, age, and sex	(4)=(3) with size of settlement
Income per capita (000 rubles at March 1993 prices)	0.012 (7.54)	0.009 (5.80)	0.009 (5.69)	0.007 (4.59)
Change in status	0.025 (5.48)	0.022 (4.06)	0.018 (3.15)	0.017 (3.12)
Expected change in status	0.039 (6.03)	0.039 (5.18)	0.032 (4.07)	0.030 (3.83)
<b>Socio-economic group (vs. full-time worker)</b>				
Part-time worker	0.151 (1.44)	0.064 (2.06)	0.055 (1.77)	0.042 (1.33)
Entrepreneur	0.183 (3.07)	0.153 (2.74)	0.130 (2.27)	0.130 (2.26)
Self-employed	0.132 (1.40)	0.144 (1.74)	0.131 (1.59)	0.135 (1.66)
Student	-0.111 (-3.77)	(omitted)	(omitted)	(omitted)
Pensioners	-0.176 (-6.42)	(omitted)	(omitted)	(omitted)
Housekeeper	0.069 (1.65)	(omitted)	(omitted)	(omitted)
Unemployed	-0.058 (-1.09)	(omitted)	(omitted)	(omitted)
<b>Job position (vs. skilled workers)</b>				
Top manager		0.117 (2.09)	0.067 (1.08)	0.081 (1.33)
Head of division		0.125 (3.13)	0.075 (1.61)	0.081 (1.74)
Professional		0.095 (3.47)	-0.001 (-0.02)	0.009 (0.25)
Clerical employee		0.068 (2.01)	0.007 (0.19)	0.012 (0.32)
Unskilled worker		0.001 (0.00)	-0.025 (-0.46)	-0.023 (0.43)
Agro skilled		-0.134 (-2.44)	-0.117 (-2.13)	-0.091 (-1.65)
Agro unskilled		-0.197 (-2.12)	-0.253 (-2.60)	0.234 (-2.39)
Servicemen		0.071 (0.85)	-0.002 (-0.02)	0.013 (0.15)
Age of household head			-0.033 (-5.18)	-0.031 (-4.87)
Age squared			0.0003 (4.51)	0.0003 (4.09)
Sex (female=1)			0.080 (3.28)	0.076 (3.13)
<b>Education (vs. technical college with less than secondary)</b>				
Primary			-0.211 (-1.52)	-0.173 (-1.26)
Incomplete secondary			0.008 (0.11)	0.021 (0.28)

Complete secondary without diploma			0.007 (0.07)	-0.013 (-0.13)
Complete secondary with diploma			0.007 (0.12)	0.011 (0.17)
Technical college and secondary education			0.066 (1.11)	0.063 (1.04)
Vocational college			0.081 (1.39)	0.080 (1.89)
3-4 years in university			0.163 (2.52)	0.159 (2.42)
Completed university			0.133 (2.20)	0.116 (1.89)
<b>Size of settlement (vs. middle-size city)</b>				
Rural and small towns				-0.058 (-1.53)
Larger towns (btw. 100,000 and ½ million)				-0.054 (-1.25)
Large cities (over 1 million)				-0.043 (-0.86)
Moscow				0.092 (2.14)
Pseudo R <sup>2</sup>	0.09	0.103	0.143	0.154
Observed probability	0.657	0.722	0.722	0.722
Predicted probability	0.690	0.763	0.774	0.775
Number of observations	2628	1593	1593	1593

Note: The omitted category throughout all regressions is a full-time skilled worker, with technical college, living in a middle-size city.

“Omitted” means that variable was omitted from the regression due to multicollinearity.

The decision to vote for Yeltsin thus only seemingly depends on a person belonging to a given socio-economic group or having a given job position. In reality, the determinants of voting behavior are the same for all—regardless of social group to which they belong. *The link is not between social group per se and voting decision; it is between other variables (like income and status), and voting decision.* The problem with reforms was that the “goodies” (good income and improved status) were concentrated disproportionately among some social groups and jobs types, most notably among entrepreneurs and managers, while similarly the losses were concentrated among other groups (pensioners and the unemployed). Thus, those who did well under Yeltsin and very hopeful for the future voted for him; those who did badly and very pessimistic about own future, voted against him. The first were disproportionately managers and entrepreneurs, the second were equally disproportionately pensioners, the unemployed and agricultural workers.

## 5. Conclusions

We have sought to demonstrate the way in which the gains from transition have been divided in post-communist Russia. We believe the evidence provides strong support for our contention that the gains have been captured by the new managerial class, who have successfully won rents from the state in the form of privatized enterprises, state subsidies, credits, and tax evasion. These rents effectively removed revenue from the

state that could have been used to support social policy during the transition, and especially pension reform. Pension reform, in turn, could have done much to fuel industrial restructuring; thus we end with a double tragedy.

For, at the present time, Russia has done little either to reform pensions or to engage in enterprise restructuring. Foreigners are reluctant to invest in a Russia that has refused to grant them clear property rights or a working judiciary and has recently defaulted on its T-bills. Due to the general lack of confidence, both domestic and international, Russians have seen their economy continue to shrink.

We situate the reasons for this dismal outcome in Russia's political and economic institutions. Specifically, Russia, unlike Poland, failed to create a pluralist politics in the early years of transition. This meant that no effective counterbalance emerged to offset managerial rent-seeking, and the state was easily captured by well-organized industrial interests. They have then been able to combine successfully with the government elite so as to guarantee to bankroll its campaign and help it win the election, in return for promises that government largesse will continue to flow. The empirical results, the voting behavior during the second round of presidential elections in 1996, is consistent with this hypothesis. It also shows that the strategy did work. The political elite was indeed reelected.

What this implies is that policy reform must always be considered in a political-economic context. Reforms, no matter how well intentioned or how well grounded in best practices, must fail to achieve their goals if they lack the institutional infrastructure needed to support them. How to build those institutions, however, remains elusive, and it is this challenge that presents the greatest theoretical and practical puzzle for the next stage of the reform process in Russia and many other transition countries.

In addition, the lessons to be drawn from the Russian case are more general. The Russian case may be an extreme example of the role of political economy in policy-making. This is because of the openness and flagrancy with which the favors were given by government, and the electoral support (money) provided in return. But the same behavior—endogeneity of economic policies—exists elsewhere. The selling of favors may not be as open, and misbehavior may not be as egregious, but the difference is rather one of degree than of kind. There are few economic policies that are made in a vacuum, by the notional incorruptible bureaucrats, to serve some abstract general interest. The reverse—particular interests, venal bureaucrats, and the exchange of favors—is the melancholy rule.





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