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How the Middle Class Will Democratize Russia

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Twenty years ago, Soviet President Mikhail Gorbachev resigned, the Soviet Union ended and Russia began an imperfect transition to democratic capitalism — a transition that has proven to be far more difficult than expected. And yet the recent protests — somewhat similar to those that preceded the end of the Soviet Union — provide grounds for cautious optimism about the future.

So, what lessons can we draw from the successes and failures of Russia's post-Soviet transition during the past two decades? And what lies ahead?

The first lesson is that market competition, responsible macroeconomic policy and private enterprise generally work. Market reforms eventually resulted in historically high growth rates. And while high commodity prices played a part, privatized and new enterprises were the fastest-growing sectors of Russia's post-Communist economy, and the government played an important role by ensuring macroeconomic stability, maintaining a balanced

budget and using oil revenues to create significant foreign-currency reserves.

Second, a market economy needs strong political and legal institutions to protect property rights and competition. Such institutions are difficult to build from scratch, and doing so is not merely a technocratic task. It requires political change.

Contrary to popular belief, Russia's reformers understood this challenge from the start. They created a completely new judiciary and tax system, established fiscal federalism and introduced an independent Central Bank, an antitrust agency and many other institutions. But they also knew that these institutions would work effectively only if there was political demand for them and that this could only come from private owners, a critical mass of which had to be created as soon as possible.

That is why the reformers rushed ahead with privatization. But because corruption was not rooted out before privatization took place, it involved substantial abuses, which undermined popular support for private property.

But the reformers' arguments eventually gained ground. Most of Prime Minister Vladimir Putin's reforms during his first presidential term were promoted and even designed by the new capitalists. Private land ownership was introduced, the tax system was streamlined, the business environment was deregulated, a stabilization fund was created, deposit insurance was implemented and credit-history bureaus were established.

But the unpopular privatization also provided support for Putin's model of state capitalism. Following the nationalization of large companies — both overt and through acquisition by state-owned companies — the government has regained control over the economy.

Russia's state capitalism is different from a planned economy because government-owned companies are supposed to compete in the marketplace and act similarly to private firms. Critics of state capitalism have always pointed out the risk of government encroachment, which is exactly what has happened in Russia, where the state-owned companies have grown so large that it is difficult to distinguish between them and the state itself.

Not surprisingly, government policy has supported these companies through regulation and subsidies, thereby protecting them from competition. Nor is it surprising that these companies failed to eliminate inefficiencies and raise productivity.

This largely explains why annual economic growth slowed from 7 percent during the period from 1998 to 2008 to 4 percent in 2010-11. Moreover, expansion of state companies drastically reduced demand for market institutions, as it also reduced the need to eliminate corruption and improve the business climate.

In the second half of the 2000s, as state capitalism came into its own, previous anti-corruption gains were reversed, and the business climate deteriorated to the point that capital flight now stands at about 4 percent of gross domestic product. That is a stunning figure, given high oil prices, abundant investment opportunities and the nearly moribund U.S. and European economies, the main recipients of Russia's fleeing capital.

In short, the third main lesson of Russia's transition is that state capitalism does not work,

at least not without a strong meritocratic political party, as in China. Indeed, recent events have shown the system to be inherently unstable. While market reforms brought substantial prosperity — average annual per capita GDP at purchasing power parity is now $17,000 — a large middle class, based mostly in small and medium-sized companies and the service sector, all developed beyond the reach of the state-owned behemoths. Most of this middle class also lives in large cities, where the battle for the country's future is now taking place.

The demands of this middle class have become crucial. Its representatives understand that they must win the battle against corruption or leave the country, as they would, otherwise, have no future in Russia. That is why they have rallied around the young blogger Alexei Navalny, whose WikiLeaks-like anti-corruption campaign has brought forth evidence of billions of dollars stolen from state-owned companies, luxury limousines bought by officials and spectacular business careers by the ruling elite's "wunderkinder" sons and daughters.

The evidence of corruption produced by Navalny and the nickname he gave to Putin's political party, United Russia — "the party of crooks and thieves" — were perhaps the single most important factors behind United Russia's large losses in December's State Duma elections. Moreover, massive electoral fraud galvanized middle-class grievances, driving tens of thousands of protesters into the streets.

Ironically, the wave of protests since then is consistent with the "modernization hypothesis" that Putin's government has always used to justify the rollback of democracy in Russia: Democracy is sustainable only if society is sufficiently well-off and has a solid middle class; until then, centralized rule is needed.

Now, it seems, sufficient prosperity has arrived, calling forth a middle class solid enough to demand government accountability, the rule of law and a genuine fight against corruption. Whatever happens in the March presidential election, the political mobilization of the middle class will eventually lead to democratization.

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