SHOULD SOVIET SPECIALISTS HAVE BEEN CONSULTED? OR: WAS EXPERIENCE IN LATIN AMERICA OR AFRICA GOOD ENOUGH?

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THE QUESTION

Either by chance or choice, international organizations such as the World Bank or the IMF did not turn to economists who had studied the Soviet planned economy when they began giving transition advice. At the time, the feeling among international organizations (and major international energy companies also) was: “If we can work in Latin America or Africa, we can work just as well in Russia and other former Soviet republics.” This paper asks whether this strategy was a mistake. Did Soviet specialists have something of unique value to offer to form transition strategy? This paper was prepared with the benefit of hindsight, but I have tried to place myself in the context of what we knew about the Soviet system as of the early 1990s.

WHAT WAS KNOWN ABOUT RUSSIA AND THE OTHER SOVIET REPUBLICS AT THE START OF TRANSITION

In this section, I list what economists who had studied the Soviet administrative-command economy knew (or should have known) in 1991:

1. Economic distortions were of a greater magnitude than had been encountered in other parts of the world.

   Studies from the late 1960s and early 1970s by Simon Kuznets, Gur Ofer, myself and others examined the economic structure of the communist countries using Chenery-Strout-type regressions and found enormous distortions in the structure of output, use of output, and trade ratios. I doubt that distortions of this magnitude could be found for any other economy. Distortions were least in the pattern of trade which Rosefielde found conformed to patterns predicted by Hecksher-Ohlin.

   The impact of these distortions on the market value of enterprises and capital stock were already apparent in 1991 through the experience of the Treuhandanstalt in Germany, which discovered that industrial assets in Eastern Germany basically had no market value. These distortions meant that Russia would have to deal with adjustments larger than had been encountered previously by international advisors. The isolation of the Soviet Union from the rest f the world also meant that there would be little appreciation of the degree to which Russian products and technology fell behind the standards of the West. In Africa or Latin America, the adjustment problem involved opening up protected markets and a few state owned monopolies to outside competition. In Russia it required a restructuring of the entire economy. In Argentina it was the restructuring of YPF, a state owned company that exhibited all of the tendencies of the Russian state company. Only in Russia, there was an entire economy of YPFs. Lack of knowledge of the enormous magnitude of the adjustment (and the implicit low market value of Russian industrial assets) could have been a hindrance. Complicating matters was the planned system's choice of incredibly high concentration ratios.

2. The "planned economy" had a rather significant market component.

    Zaleski discovered that plans played a relatively small role in Soviet resource allocation. Rather resources were actually allocated by ad hoc decrees and by transactions that took place below the radar screen of planners. Transactions among enterprises were regulated by "relational contracting" based on reputation and custom. Very few commodities were actually allocated by plans because plans remained above the level of actual transactions. This phenomenon was noted by Kornai, who wrote that actual resource allocation is done by contracts that may or may not be related to plans. In addition to this "wholesale" market, there was a large retail "second economy" (discovered by Grossman and Treml) that accounted for about 15 percent of retail transactions. Soviet reformers had written extensively about creating "direct links" but I suspect that direct links were already there, based on custom, habit, and some planning.

    Importance: There was already a poorly understood market in the Soviet Union at the beginning of transition. By the end of the Soviet Union, there was even debate as to whether this was a planned economy. The issue is similar to the one raised by Stiglitz: If Russia had rudimentary market institutions (such as direct links and relational contracting) could Russia have built on these rudimentary institutions as a bridge to more sophisticated market institutions or should Russia have started from scratch. In the early 1990s, I noticed among Russian reformers a desire to move institutions too fast and to go directly to more sophisticated market institutions, such as futures, derivatives, computerized trading, rather than starting with more fundamental market institutions.

3. Lack of property rights had created in the Soviet period a long-term inbred tradition that public property was not to be used for public benefit.

In the Soviet period, the expression was "property belongs to everyone and hence to no one." There was a long tradition that public property was to be used for narrow benefits – personal, local or regional. These problems had been well anticipated by Hayek and Mises in their early critique

of planned socialism. The perks and privileges of managers were tied to the job, and uncertain job tenure promoted a misuse of property, bribe taking, and accumulation of illegal cash.
Importance: Market economies are constantly evolving to find better ways to create incentives to use assets efficiently – stock options, bonuses, etc. Market economies are still plagued by enormous principal/agent problems with respect to the use of property. In a country that is just developing the notion of private property and with a long tradition of misuse of property, finding ways to encourage the rational use of property would be expected to be the most difficult and time consuming part of the transition process.

4. There was no real "rule of law" in the Soviet economy

One would have expected that an administrative-command economy, based as it was on written orders and formal hierarchical structures, would have had a well defined "rule of law." If one examines, however, the charters of ministries or enterprises, these charters say that it is the obligation of the organization to "fulfill the plan." But the plan was multi-dimensional, was changed frequently, and was compiled at a high level of aggregation. Worst of all, the plan was contradictory. Hence, there was no way for any "manager of production" (khoziaistvennik) to operate in a fully legal fashion. "Good managers" knew how to fulfill the plan "at any price" (liuboi tsenoi). Hence, the Soviet economy was one in which its managers operated without a real formal rule of law.

Conclusion: For a country that had operated on the basis of customs and informal relations, largely designed to circumvent the limited "rule of law" that existed, it would be hard to appreciate the importance of the rule of law. This would be a foreign concept for business persons, but it would be extremely important for foreign investors. In the early days of transition, Russian officials could not understand why their word or assurances was not sufficient to attract investment and the degree of misunderstanding between Russian officials and potential foreign investors was enormous/ In this climate, therefore, no one should have expected significant foreign investment for a long period of time. Virtually all investment would have to come from local sources.

5. Resources were allocated primarily by industrial ministries and their main administrations, not by the center. There was an enormous concentration of expertise within industrial ministries that was not easily transferable to other activities and that was bound to dominate the branch after the end of the Soviet period.

The center could plan and balance, at best, one to two thousand commodities, operating at high levels of aggregation. The real centers of resource allocation powers were the industrial ministries and regional authorities. The Soviet educational system was basically operated by the ministries and it produced "branch loyalists" who felt that their careers depended on the fate of the branch. There was relatively little movement among branches and few obtained general educations that would qualify them for work in other sectors. The leaderships of the industrial ministries constituted a tight knit group that was strongly inbred. It constituted the core of experts knowledgeable about that industry. It would therefore be expected that this core group would have to continue to operate the industry.

6. The absence of a rule of law, the need to violate the law, and the need to find "scapegoats" for failures created a decision making process that minimized risk and made significant change difficult.

Berliner showed that the Soviet system did not provide adequate rewards for risk taking. There was an asymmetry between risks and rewards. Risky decisions that turned out poorly were punished. Risky decisions that turned out well were not rewarded. Decision making processes which reduced the risks to decision makers became ingrained. One such process, which survived into the post 1991 period was the process of vizirovanie – the fact that all parties affected by a decision would have to sign off on that decision. Vizirovanie is a version of governance by unanimity, which is cumbersome and practically unworkable.

Conclusion: Any process of "fair" or "legal" privatization would have been killed by vizirovanie. There had to be strong rewards (unfair privatization) offered to overcome the bureaucratic obstacles. Privatization is an inherently risky venture for those managing it. If Russia wanted privatization to take place within a period of 4-5 years, the only way was for it to be grossly unfair.

7. The supply of reformers with good intuition about markets and skills in markets was severely limited.

Most Russian reformers had been taught as mathematical economists. They had little experience in real-world market economies and either idealized them or reviled them. I encountered a number of "reformers" who were still tied up by the "balance mentality", the notion that important goods simply cannot be allocated by the market. If a good is vital, such as energy, it cannot be turned over to the market. Of course, "material balances" were the core of the Soviet administrative-command system. It must have been hard to overcome this balance mentality. Moreover, there were relatively few specialists in Russia with skills suitable for creating the institutions of a market economy. In a project that advised the Russian government on energy legislation, it was discovered that in 1992, there were maybe two specialists in all of Russia that had some reasonable skills in energy law. Those with market skills were concentrated in foreign trade operations and from KGB language programs and international assignments. They would naturally be the beneficiaries of any new market economy.

8. The Soviet command economy understood well how to control inflation and had done so for decades.

Although the Soviet leadership feared a massive monetary overhang, a number of Western economists demonstrated that the Soviet saving rate was fairly normal. A massive saving overhang did not threaten Russia, and if it did, it would have led to a one shot adjustment in the price level. The Soviet leadership, throughout the Soviet period, well understood the quantity theory of money (expressed as a balance of purchasing power and the supply of consumer goods at prevailing prices). The communist party was itself involved in limiting the growth of the money supply. The inflation that occurred was a consequence of having 15 central banks for a transition period. Given the unpopularity of inflation, it is my guess that the Russian leadership itself would have produced a reasonable rate of inflation with or without pressure from international organizations. If Russia were able to produce by itself a reasonable rate of inflation, the anchor of a controlled exchange rate could have been dispensed with, and Russia would have had a much freer hand in its economic policy. The foreign debt that Russia accumulated for propping up its currency could have either been avoided or devoted to productive uses.

9. Western political scientists had argued that the Soviet Union was no longer a centralized dictatorship by the 1970s. Rather it was already dominated by vested interests.

The Soviet Union was an agglomeration of vested regional and industrial interests in which the communist party played the role of mediator or referee. It would therefore be expected that these vested industrial and regional interests would play a dominant role in the post-Soviet period. Russia’s problems of economic policy were therefore more “political-economic” than economic. To overcome these vested regional and industrial interests, Russia would have required an extremely powerful president, and the Yeltsin Constitution can be characterized as such. Yeltsin, however, lacked the political power or devotion to “encompassing” goals to deal with these vested interests. One of the most striking features of the Russian transition is the high survival rate of the old elite, particularly the regional elite. These survival rates suggest an economy that will be dominated by narrow interests in which it would be very difficult to establish a "level playing field" for all.

10. The Soviet period generated a real disdain for small business and services.

From the 1920s on, small businesses and providers of services were regarded as speculators, basically dishonest, and the like. It was therefore unlikely that there would be a favorable climate for small businesses in present-day Russia. This disdain was enhanced during perestroika during the cooperative movement, which was blamed for the first price increases and product shortages. Unlike Poland where economic growth has been based on small businesses, Russia still has to develop a class of small business men and they probably operate under the least favorable circumstances of all Russian business today.

11. Russia in early 1992 may have been one of the few countries ever that had no economic system.

The heart of the Soviet system was the industrial ministry and the "leading role of the communist party." Both institutions were destroyed by 1990, and Russia was left with a vacuum. I imagine there have been few cases in economic history of a major country without an economic system. In this regard, Soviet specialists have little to offer in terms of an alternative because the various possible reform of the Soviet system had all been tried – full economic accounting, changing success indicators, some decentralization of input and investment choice. All had been rejected. At the end of perestroika, Gorbachev in effect tried to install the Chinese system of reform but that failed as well. One of the great issues is whether there was some intermediate solution that could have avoided these 2-3 years devoid of an economic system?

12. In retrospect, Soviet specialists now agree that we grossly overestimated the level of economic development of the Soviet Union and we hence overestimated Russia's prospects.

The most widely cited estimates of Soviet GDP placed it at about half that of the United States. Living standards were around one third of the United States and compared favorably to Italy. We now recognize that these estimates were far from the mark, especially when any type of market-price valuation is used. The overvaluation of Soviet economic power caused us to have to high an expectation as to what Russia could accomplish. It would have been wise to debate a reasonable end goal for the first two decades of Russian growth – Turkey, Israel, Syria?