TITLE: The Mirage of Soviet Economic Reform

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DATE: June 1991

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Richard Ericson on The Mirage of Soviet Economic Reform

On February 26, Harriman Institute Professor of Economics Richard Ericson spoke on “The State of the Soviet Economy Today.” Ericson gave a detailed review of the current economic trends in the USSR, followed by an analysis and assessment of these trends, and predictions about what might happen in the near and medium term future.

How Bad is Bad?

In offering his review of the situation, Ericson began with two differing views on the state of the economy. One view holds that things are not as bad as they seem. Rather, the Soviet economy is like a truck "stuck in first gear." Proponents see it as "moving slowly, and if they can just get out of that, things will start getting better fairly rapidly." The reforms just need time to get going, some believe. Others see the opposite situation: an economy undergoing "disastrous disintegration," with little to look forward to except "general chaos." The truth, says Dr. Ericson, lies somewhere in between, "but perhaps closer to the second than the first." It is, he said, like "a truck that has stripped its gears" with a horse hitched to it, trying to pull or push start it, "using more or less traditional methods."

This is evidenced, says Ericson, in the year end results for 1990. He went on to explain that these results arose in large part from the policy decisions of the Soviet government, in the form of presidential decrees by Gorbachev and some of the recent measures taken by Prime Minister Pavlov aimed at "some sort of conception of stabilization," with a lot of rhetoric thrown in about preparing the way for real marketizing reforms. But these measures are not really helpful in creating a "working market system," said Dr. Ericson. Instead, "we seem to be heading for some sort of an unstable hybrid" in the near future. This hybrid will still present them with the choice of whether or not to go ahead with serious market oriented reform or to back off into some sort of weakened version of the command economic system "that they have come to know and love."

The latest economic figures from the USSR show an acceleration of the economic downturn from the second to the fourth quarters of 1990. Official consumer markets are collapsing, with only 20 of 1200 consumer necessities regularly available. Other indicators of this collapse include the growth of rationing, more and more alternative monies (Ukrainians being paid in locally valid coupons in addition to rubles), alternative direct distribution (workplaces distributing foods directly to employees), growth of local protectionism (proof of residence required for purchase in some areas), and barter deals. There has also been an explosion of local market experiments such as fairs and exchanges. They are thin markets, however, and usually run out of things to exchange in a week or so. The black market is also rapidly expanding, and thousands of citizens are fleeing from the ruble as a means of payment. The “flight from the ruble” has been accentuated by the fact that it was until March, 1991, legal for Soviet citizens to hold and spend foreign currency, although it was still illegal to obtain it.

Together with the collapse of consumer markets, there has been an “unravelling of state production” that has further promoted the expansion of black markets at the expense of state channels. Even in official Soviet statistics Soviet gross national product declined 2% in 1990, national income was down 4%, labor productivity slipped 3%, industrial output slipped 2%, and agricultural output fell by 2.3%. The only area of improvement seems to have been in production of consumer goods, which increased by 6%. This is a misleading figure, however, as almost all of this increase is contained in production of non-essential consumer durables and luxury goods. Production in all industrial sectors declined.
except for machine building, which has the most complicated assortment and therefore the one subject "to the most upward exaggeration" in reported output. But even there, the share of world-quality production in the USSR dropped from 13% in 1989 to under 10% in 1990. Social construction was down 15-20%, only 31% of all industrial construction begun in 1990 was completed, and subcontracting fell 8%. Transportation of freight was down 6%, exports dropped a 12%, while imports dropped 2%, thus exacerbating the current account deficit of foreign trade.

The End of the Plan

One of the reasons for this rapid decline has been the absence of a strong centralized plan, the heart of the Soviet economy since the 1930s. Whereas by January, 1990, contracts were signed for the use of 90% of industrial capacity, by January, 1991, only 78% of that capacity had been contracted for use. In light and consumer goods, this number is closer to 70%. While this is not indicative of a total collapse, it is a clear sign of serious economic "unravelling of production." In fact, earlier this February, it was reported that Prime Minister Valentin Pavlov said January 1991 output was only 50% of January 1990 output. This should be considered extraordinarily low. Further evidence of this unravelling is taking the form of inflation; the consumer price index increased officially 6.8% in 1990, while retail prices increased 5.5%. In the normally stable state retail sector, prices went up 4.3%. The greatest inflation occurred in private markets where "prices are less subject to administrative control." In city and cooperative markets, prices went up 8.7%, while in farmers markets prices shot up by 29%. In December alone, farmers market prices skyrocketed 150%; inflation is increasing at an increasing rate. In general, the official statements say that all inflation, including repressed inflation, ran at about 19% for the year. Thus, the stringent controls that the government used to place on all sectors of the economy are falling apart.

Ericson continued with numbers that demonstrated not only the weakness of the Soviet economy, but also its apparent chaos and inability to set itself straight. One example is the exchange rate for the ruble at auction, a device designed to enable Soviet firms to exchange their rubles into dollars. The rate has generally increased since January, 1990, rising from 10:1 to 25:1, with only a slight drop in October-November when real reform looked possible. Thus the incentive for foreigners to try to do business in the USSR meets yet another complication. Another complicating factor is the combination of dramatic increases in the money supply (150%) and interenterprise credit, with a much smaller increase in income and personal savings. The combination of the dramatic increase in money, the increase in both wages and savings, and the stagnant state of consumer durables production has created "tremendous inflationary pressure" in the economy, pressure that the government seems either unable or unwilling to deal with.

The "energy crisis" is yet another area demonstrating the deterioration of production. Electric output was "essentially constant", and gas production rose 2%. However, coal (down 5%) and oil (down 6%) production dropped 50% faster than they had been falling in 1989. This has led to serious brownouts and even to some blackouts in places like Georgia and some "fairly significant cutbacks in industrial production" as industry has had to make do with less energy.

Ericson concluded his pessimistic review of the current situation by noting two more significant developments: the development of local and regional economic power centers and the breakdown of normal, regular economic activity. Many areas in the USSR, ranging from Union republics all the way down to cities and even neighborhoods are attempting a sort of economic secession from the union. These new economic centers are trying to become as autarkic as possible in an attempt to escape the economic chaos that seems to reign throughout the country. They then attempt to "cut their own deals" and secure "mutually advantageous barter arrangements" with other such centers, necessitating high levels of local protectionism so that the central authorities cannot take goods that are being bartered. Official contracts calling for transfer of inputs and resources between economic agents are suffering heavily as a result: people want to control their own resources and make their own deals so they can benefit. But instead of actually becoming autarkic, independent, which most such "centers" are not really able to do, this secessionist spirit is simply adding to the country's woes by further complicating economic transactions among such centers. This leads to the second point, the breakdown of normal and regular economic activity. Instead of sending and receiving goods freely amongst themselves, these rising centers, in their attempts to become autarkic, are disrupting the established patterns of commodity flows. This is having real and detrimental effects on the economy.

New Possibilities

Despite the seeming endless list of bad news, Ericson pointed to a few features of the current Soviet economy that give room for hope. The cooperative sector of the economy is one such feature. The main problem with cooperatives is that 80% of them are "subsidiary or parasitical to the state industrial sector, essentially de-
partments of state industry," directly attached to and serving the devolving state economic structure. But since they are not ruled by the strict administrative rules of the state structure, they can serve the official economy at a much lower cost. Less than 20% of all cooperatives in the Soviet Union actually provide consumer goods and services. There are approximately 260,000 cooperatives now, with about 2.7 million full time of 6.2 million employees. So while the potential exists for cooperatives to serve the demands of the consumer goods market, no mechanism exists for this service on a large scale. Another possible source of hope is in leasing of government property for use in quasi-private ventures. By 1991, 5.2% of all industrial output was produced by leased ventures. But the scale at this time is too small to make a real difference and it is not clear where the role of leasing is headed in the Soviet economy.

Joint ventures, seen by many in the west as well as the USSR as a panacea for what ails the Soviet economy, are not having the desired effect either. There are approximately 3,000 joint ventures in the Soviet Union today, with a capital base of only about 6 billion rubles, a tiny fraction of Soviet capital stock. Further bad news is that of this 6 billion rubles, only about 2 billion, one-third, is capital contributions by foreigners. So the hard currency investment that could go toward helping the economy is reaching it in only very small amounts. And while the number of joint ventures seems quite high, and is relatively much higher than several years ago, they are for the most part not employing large numbers of Soviet citizens or doing large scale business operations.

Reasons for Failure

Why has the system failed so badly? The nature of the political environment is the first reason Ericson offered. Since the Soviet economic system has for so long been based primarily on legal and administrative procedures rather than market forces, the breakdown in the legal and administrative systems that control the economy, "the war of laws, the war of autonomous" is a "sufficient condition" for the devolution of the economy. The political and legal confusion of the past several years has led to a concomitant confusion in the trading of commodities. There has been a total breakdown in two of the primary linchpins of the Soviet economy: the uniform (and non-market) price system, and the unilateral and legal enforcing of contracts according to dictates laid out in the five-year plan. Approximately 40% of all firms are failing to fulfill all their state orders and contracts, with seemingly no recourse to enforce them. The figure is probably higher due to underreporting in processed goods manufacturing, where the opportunity exists for "manipulation in assortment and how you interpret the requirements of the contract." This is representative of the extremely deep economic problems endemic to the Soviet Union. People understand that they can get away with signing more than one contract at once for several goods, knowing that some orders will necessarily go unfulfilled. Lack of contract fulfillment has ripple effects throughout the economy, such as idle factories, empty shelves, etc.

The primary problem, as Ericson sees it, is "the absolutely bizarre system of valuations and system of pricing of all economic activity, all economic assets, all goods and services in the Soviet Union," as well as the total absence of real property rights. Without the two critical defining parameters of property and a pricing system that reflect scarcity and value, people lack any real economic incentives and indicators; they instead engage in what Ericson termed "rent seeking and asset stripping." That is, people take what they need when they can get it wherever and however they are able to regardless of the damage it may cause, since nothing truly belongs to anybody, outside of insignificant levels of personal goods. This rent seeking has serious consequences on the health of the system and is "endemic both within and outside the state sector." from industrial tolkachi (expediters) who obtain inputs for industry in the technically illegal but unofficially sanctioned gray markets at the expense of other factories and industries that lose out on those inputs, to small and large black marketeers (including "mafia activity" on an enormous scale) who steal state property either from work or by outright thievery and either sell it or keep it for personal use. The economy is thus stripped of much of its output, output that is appropriated illegally and cannot be controlled.

Tendencies of Reform

Rather than solve the legion of problems facing the Soviet economy, perestroika has exacerbated certain problem areas and even created some problems of its own. The two main tendencies that the reforms caused, according to Ericson, are "the loosening of the administrative constraints" that held the economy together and the "monetization" of economic activity. People are now engaging in economic activity completely independently of what the economy requires. Reform has loosened administrative controls on the economy, ostensibly in favor of letting economic incentives take over. But these economic signals are neither able nor allowed to function properly in the USSR because the "totally bizarre system of valuation" still prevails and does not give proper economic signals; there is no way for anybody to know what other sectors or actors in the economy need or really want. As a result of the lack of proper, system-wide economic signals, people engage in highly individual-
ized economic activity, taking advantage of the loosening of command-administrative restraints and trying to improve their own lot irrespective of others'. This shows up primarily in the change in assortments of production—factories producing what they want in whatever amounts they want, based on what they perceive to be most profitable and easy to produce, independent of what the economy and consumers really need. A good example is the "tremendous growth in video cassette recorders available to consumers, which nobody really wants. They would rather have can openers and jars and all sorts of things that are necessary for ordinary life."

The "monetization" of economic activity involves the distorted role that money plays in the Soviet economy. Ericson argues that there is nothing in the Soviet economy that we could call real money. The paradox arises when the system of central command is dismantled (as it is being presently) but there is no system to give people proper signals to tell them with whom they should conduct economic activity and how. In western market economies, a free and open pricing and valuation system based on money plays this role. This is the basis of the "profit incentive." But it only works in a system with a real money, which must "really bind, be sufficient and necessary to consummate any transaction, is a generalized command over goods and services both now and in the future. That object they do not have. The ruble is at best a highly passive, fictitious quasi-money. It comes in virtually unlimited amounts, is pumped out by the state bank as needed, because the absence of rubles can never get in the way of implementing a state order or any required activity. And furthermore it has to be practically useless because an accumulation of rubles can never be sufficient to bleed away resources from state activities to support unplanned activities."

There is chaos at all levels of economic activity in the USSR today. The problem is not that there is any more or less money in the economy today; rather, the ruble is now expected to play a role that it is not capable of. It is now expected to function as a true money with all of the aforementioned characteristics, but it is simply incapable of doing so. "It is supposed to provide signals and incentives," which it cannot, "and therefore it becomes chaotic." In the traditional system, money was neither necessary nor sufficient to conduct transactions. So the state could either withhold, confiscate, or dole out both *nalogliche* and *beznaliche* rubles as it saw fit. Now that that system is no longer functioning and money is supposed to play a real role, it plays a very disruptive one "because of its unreality."

Finally, all of this is aggravated by "extreme economic imbalances, true disproportions built into the system." The disproportions are between costs and expenditures, value and prices, and capacities and needs. This last disproportion is staggeringly disruptive, says Ericson, and arose due to the highly aggregate nature of planning. Plans seem to work fine at the highest levels of aggregation, but when the plan has to be disaggregated out among 34 million different specific commodities, each requiring specific kinds of inputs, "the disproportions are absolutely phenomenal and truly disruptive of any kind of move to a rational structure of production." This is the legacy of 60 years of "constructing an industrial and capital structure totally innocent of any conception of economic value and economic rationality." The result is not the basis for an efficiently functioning economy. Rather, it resembles a military structure, where "as long as people do what they are told, things hold together, and when you either stop telling them or they stop obeying, then you begin to get the kind of chaos that we see, an unravelling of the levels of economic activity."

**Current Policies**

Ericson then turned to an evaluation of the current economic policies being implemented by the Soviet government. These policies, usually taking the form of presidential decrees, "only address part of the problems and indeed, almost uniformly fail to come to grips with the root of the problems, that is with the nature of the economic system," said Ericson. Further, the policies are not really conducive to a transition to any kind of market system. There are some vague plans, such as President Gorbachev's plan, which is "long on declamation and short on details." The reason for the lack of details, says Ericson, is that the plan's writers do not understand what they are trying to do.

The first set of presidential decrees dealt with maintaining state orders and reasserting stable, long-term supply relationships. This was very harmful to any attempts to create a market system, essentially freezing in place non-market forces. A positive but limited decree favoring a market was the liberalizing of foreign economic regulations, allowing things like 100% ownership of businesses in the USSR by foreigners. However, while making it easier for foreigners to open businesses in the USSR, it did not make things any more economically feasible. Another negative decree was the confiscation of almost all hard currency earnings of Soviet firms "under the guise of providing a stabilization plan" to pay back past debts and provide money to import necessary goods. Further, tight export and import controls were recently imposed by decree, preventing Soviet businesses from importing or exporting many of their goods. This deprives Soviet economic agents of much of the real legal incentive to engage in foreign economic activity. Another decree dealt with "contract pricing" for a large
portion of industrial output, "subject to various kinds of profit control." This involved confiscation of earnings in case one's pricing resulted in too high a profit. Again, this involves the highly illogical price structure, since people must obtain industrial inputs largely at state mandated prices, and prices are thus controlled by non-economic constraints. Contract prices are determined by "bi-lateral, highly restrictive, monopoly agreements between a sole provider and a sole user." There is little semblance of market pricing in this contract system. Still another decree increased the interest on savings accounts. This required tying up savings accounts for long periods of time in order to earn up to 9% interest, thus discouraging personal consumption. But this has not proven to be effective, as even the official inflation rate is 19%, more than double the interest rate of the long term investment, "hardly a way to attract savings." There was a decree protecting private property, which was actually "a decree protecting Party property," which prevented nationalization of Party property by local and republic (i.e. non-Party controlled) governments. There was a decree authorizing KGB raids on non-state organizations, "ostensibly to look at the books for manipulation of various sorts." This has a "chilling effect" on entrepreneurial activity outside of the state sector.

Further, there have been more and more severe restrictions placed on non-state sector trade. At the end of last year there was a strengthening of the anti-speculation laws, "basically ruling out any free trade where you sell for more than you paid." A more liberalizing measure, but one not guaranteed much success, is the measure requiring eastern European nations to trade in hard currency. Another policy put into effect at the beginning of this year is a major increase in wholesale prices of 1500 basic commodities, largely raw materials for basic industry. The price of oil, for example, went up 130%. The primary effect of this was "to increase dramatically the need for state subsidies" of industries that use these basic inputs. A new stabilization fund was created, with a state sales tax of 5% to finance it. This is "neither good nor bad," but is another barrier to trade. It is, however, "vanishingly unimportant" compared to the other, physical barriers to trade in place now. However, the stabilization fund is a "very questionable activity." It seems that its purpose is "to rescue the irrational activities that might be threatened by any kind of quasi-market forces that are introduced." This is "precisely the opposite direction" from what they should be doing.

When Valentin Pavlov became Prime Minister, he emphasized that heavy industry was a priority of his administration. The first step in supporting this was a "dramatic increase in investment allocations to the energy sector." This is not "overly supportive" of a market reform process. Pavlov's monetary reforms leads one to believe this as well. The withdrawal of 50 and 100 ruble notes was "essentially an attack on private wealth" that did not get very far because cooperatives are so tightly connected with state organizations and most of the private wealth managed to slip through the channels that connect cooperatives to state organizations. It did reduce the ruble overhang a little bit, but overall its distributional impact was borne primarily by low income workers "who had saved their life's earnings in fifties and one hundreds at home rather than by the speculators it was supposedly aimed at." A more promising policy of Pavlov's, yet to be implemented or even proposed officially, is a plan "to abolish Gosplan and all industrial ministries," with the exception of heavy industry ministries and the ministry of transportation and excavation equipment machine building.

Finally, one sees in the actions of the legislature a "systematic attempt to build a procustean bed of arbitrary, economically ignorant laws on which they think a market system is going to be able to arise." Ericson pointed in particular to the law on property, which does not allow real property rights, "banking that does not allow real banking activity," laws on stocks that misinterpret the meaning of stocks, the law on joint stock companies that sets up "all sorts of absolutely bizarre restrictions" on their activities. Point by point, Ericson said, they are setting up laws that try to build "something safe, controllable, that won't be disruptive." But in trying to go from a command economic system to something as "completely different in virtually every aspect of its nature and functioning as a market economy," it is impossible to do it in a non-disruptive way. They are setting up barriers to a market system in hopes of stemming the disruptive tide, while attempting to create a market's form. They are getting a sort of stylized form of market activity without any of its essence.

From Here to Where?

Where is all of this activity leading? asked Ericson to conclude. In the medium run, it is "heading toward chaos." They are "destroying a number of the necessary components of a command economy while maintaining and even reinforcing several others." This combination is "irrational from either the logic of a administrative system or the logic of an economic system." They will, said Ericson, lose any effectiveness that they might have had in their command economy, including the mobilization of resources to achieve priorities while "maintaining at best the low level of efficiency of that system and probably losing something on efficiency grounds" anyway. The command economy "stands as an organic whole, and must be wholly replaced by a coherent eco-
nomic system if it is to be replaced at all." This does not mean immediate collapse. Rather, "inertia will maintain an ever-devolving level of economic activity." This will continue until several large firms or industries reach the breaking point. Until economic activity becomes non-viable on a large scale, and at what level this occurs is not known, there will be economic activity at ever lower levels until "real constraints" are hit. One such example is a machine tool factory that recently shut down and sent all of its workers home because it was not getting deliveries, no one was fulfilling their contracts, all state war reserves had been used up, and it was left with no alternative but to shut down. The workers, by the way, may still be collecting their monthly pay; still this may have a positive effect on GNP despite the closure.

Pressure will grow as the devolution accelerates "for a strong hand to intervene to maintain coherence," which is apt to "lead to administrative action to counter obvious distortions and breakdowns." There will also be more calls for "systematic coordination at the center to hold off further disruptions." The natural tendency will therefore be "to attempt some kind of a return to a more centrally planned, more administered economy than we have seen in the past four years." That would be the easiest and most coherent structure to build on what is currently standing. The alternative is for the chaos to "become truly endemic," leading to a "full system breakdown. On the ashes of that one might see a market system arise" as happened on the ashes of post World War II Germany. Any other path of economic evolution, such as the incoherent vision that Pavlov has "is at best a mirage."

_Reported by Joshua Larson_