

Soviet Economic Reforms: Possible Difficulties in the Application of Public Choice Theory

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Received March 13, 1990

Popov, Vladimir—Soviet Economic Reforms: Possible Difficulties in the Application of Public Choice Theory

This paper analyzes the recent Soviet experience of economic reforms, outlines the major options that face economic reformers in the Soviet Union, evaluates the political feasibility of these options, and speculates on possible scenarios of future economic development. The role of public choice theory in analyzing the present politicoeconomic situation in the Soviet Union is considered. *J. Comp. Econom.*, June 1991, 15(2), pp. 304-324. Institute of the USA and Canada, Khlebny per 2/3, Moscow 121069, USSR. © 1991 Academic Press, Inc.

Journal of Economic Literature Classification Numbers: 025, 027, 052, 124.

There are three factions of deputies in parliament, each having one vote: conservatives, centrists, and radicals. The chairman is neutral, doesn't participate in voting, but just puts the issue to a vote. The first proposal: increase salaries to conservatives, give every centrist a car, and put radicals in solitary confinement without the right of correspondence. The proposal is approved by a two-thirds majority. Next proposal: give a car to every conservative, grant the right of correspondence to the arrested radicals, and put centrists in solitary confinement. This one is also approved by a two-thirds majority. Finally, another proposal: to move centrists and radicals to a common cell, allowing them to receive parcels, and put the conservatives in the same cell. So, all deputies meet each other in the same common cell since the last proposal is also approved by a majority . . .

J. Feofanov, *Izvestia*, Sept. 6, 1990

Economic reforms, unfolding now in the USSR, are causing great debates everywhere, and certainly in the Soviet Union itself. There are numerous

comments about what the Soviet government has already done wrong, what its policy should be, and what will happen if necessary measures are not implemented. Glasnost brought to the surface a tremendous variety of opinions, which were suppressed before, and therefore there is now an extreme diversity of programs, ranging from the far left to the far right.¹ The party leadership and the government seem to occupy the center in this debate, but many observers consider the situation unstable and warn that this shaky and delicate political balance may easily change.

How will economic policy change in the near future? What factors influence this change? What is the best scenario for economic restructuring and assuring a low cost transition from a command economy to the market? Is this optimal scenario politically feasible? What will happen if this scenario fails to materialize? Answers to these questions evidently lie in the framework of public choice theory and at the same time are of crucial importance in evaluating the chances for the success or failure of economic perestroika. In fact, in Buchanan's (1984) words, "public choice offers a 'theory of governmental failure' that is fully comparable to the 'theory of market failure' that emerged from theoretical welfare economics of the 1930s and 1940s." Although the political process in the Soviet Union still differs greatly from that in the West, public choice theory offers at least an appropriate analytical setting for the discussion of these issues.

The purpose of this paper is to analyze briefly the recent Soviet experience with economic restructuring, to outline the major options that economic reformers in the Soviet Union now face, to evaluate their political feasibility, and to speculate on possible scenarios of future economic development.

1. DID WE MISS A CHANCE?

Despite many shortages in the Soviet Union, there is no shortage of ideas on what should have been done in the first years of perestroika. Yet, to be fair, it is necessary to confess that several years ago there were some economists who suggested a package of measures that has still not been implemented. These measures were a sort of a program for national economic revival and resembled Shatalin's 500-day plan of September 1990, which was based heavily on ideas put forward in 1987-1988. If this program had been adopted several years ago, the Soviet economy now would probably be much better off.

¹ The notions "left" and "right" are used in a peculiar way in the Soviet Union these days. The leftists or radicals are the strongest advocates of perestroika, a market-oriented economy, democratic institutions, etc. The rightists are against marketization and privatization, depolitization of the army and KGB, etc.

The plan was based on the fact that the economic heritage of the Brezhnev era was, probably unexpectedly, not all that bad. Moreover, in comparison with today's situation, it looked impressive: the government budget deficit and international indebtedness were lower, the consumer market was closer to equilibrium, and consumer prices were rising more slowly. In fact, the government budget deficit increased from less than 50 billion rubles in 1985 to 120 billion in 1988 and remained at a level of 100 billion rubles in 1989 and 1990.² Net hard currency international debt increased from \$16 billion in 1985 to \$32 billion in 1989.³ Delayed demand, the difference between the growth of personal disposable income and the growth of retail sales, increased from 60 billion rubles in 1984 to 165 billion in 1989 or from less than 20 to 40% of retail sales.⁴ Using this favorable heritage, it would have been possible to make a transition to a market economy quickly and painlessly, provided that three major sets of reforms were implemented decisively and simultaneously.

First, it was necessary to destroy the old administrative system of centralized planning to create room for the operation of market forces. The idea was to reduce drastically obligatory state orders for enterprises to less than 50% of productive capacity and to place these state orders on a voluntary, competitive basis, to replace the system of rationed supply with wholesale trade, and to deregulate prices and let them balance supply and demand. This implied that industrial departments and regional authorities would be deprived of a major part of their economic power, that peasants would be allowed to quit collective and state farms, taking land and other means of production with them, and that state enterprises would be treated in the same way as cooperatives. The idea of radical economists was to proceed with these reforms quickly. A gradual, step-by-step reform strategy would be expensive and dangerous, because in the period when the old economic mechanism was no longer working and the new one was not yet working, distortions, costs, and social tensions would be inevitable.

Second, there were proposals to create mechanisms of market regulation. In early transition, many markets would be highly monopolized and therefore there would be a slump in production, price increases, bankruptcies, unemployment, etc. Besides, structural shifts would be associated with the necessity for many workers to change jobs and occupations and with rising

² *Narodnoye Khozyaistvo SSSR*, v 1988 gody, p. 624, 1989; *Izvestia*, Sept. 26, 1989; Jan. 28, 1990.

³ "The Soviet Economy Stumbles Badly in 1989," presented by the CIA and DIA to the Technology and National Security Subcommittee of the Joint Economic Committee, Congress of the United States, p. 37, 20 Apr. 1990.

⁴ *Narodnoye Khozyaistvo SSSR*, various years.

income inequalities. To minimize transition costs, it was suggested that special measures should be adopted to neutralize negative consequences: anti-trust legislation and competition policy; restructuring of the whole system of retraining of employees and labor force policy; strong social policy including unemployment insurance, family allowances, pensions, and indexation of fixed incomes; and monetary and fiscal policies to remove excess money, establish a normal central bank and independent commercial banks, and create a set of consistent macroeconomic policies.

Third, as every major restructuring is accompanied by costs, and costs, unfortunately, come first, it was necessary to be prepared to meet these costs. It was evident that the reallocation of resources would be associated with recession, due to the conversion of production from defence to nondefence goods and from investment to consumer goods. Thus, it would be necessary to raise funds to support living standards and investment in crucial areas during the downturn. In the Soviet case, perestroika's costs were associated with the need to liquidate the monetary overhang and thus to establish equilibrium in the consumer goods market without substantial price increases; to raise expenditure for welfare programs; to increase investment in education, medical care, and housing; and to increase investment to replace capital stock.⁵

Different ways to raise funds, such as internal borrowing, privatization or leasing of government assets, reduction of military expenditures, regaining budget revenues by stopping the antialcohol campaign, international borrowing, and foreign direct investment, were suggested. Proposing all these methods, some radical economists were, however, most enthusiastic about borrowing abroad. This issue finally became the major factor in the discussion.

Those advocating foreign borrowing used the following logic. Soviet net international indebtedness in hard currency was relatively low (\$26–27 billion in 1987–1988), gold reserves were large (up to \$25–30 billion), and there were large credits in rubles to developing countries.⁶ This would enable the Soviet Union to borrow hard currency for importing consumer goods to saturate the market. As rough calculations indicated, borrowed funds would have been sufficient to survive the transition without a reduction in living standards of major population groups. Also, external borrowing and foreign

⁵ This was not only a structural disequilibrium (shortages), which is in fact inevitable in any centrally planned economy, but, for the most part, a general disequilibrium, caused by excess money printing and by the fact that prices were fixed at an artificially low level.

⁶ Eighty-six billion rubles at the end of 1989 (*Izvestia*, March 1, 1990). Data for earlier years are not published.

direct investment seemed to be preferable, giving the possibility of increasing consumption without major cuts in investment, while all other ways were associated solely with the redistribution of national income. Internal borrowing or sales of state assets were a good means of eliminating the monetary overhang by making forced savings voluntary, but were inappropriate for counterbalancing a reduction in living standards, due to the slump in production that would be caused by restructuring.

In the mid-1980s, nearly 20% of Soviet national income was spent on defence, another 30% on investment, and just 50% on consumption, while corresponding data for the United States were 7, 6, and 87%, respectively. Overinvestment was caused by losses resulting from the very nature of centralized planning, low capacity utilization and large inventories. At the same time, the size of these losses was an indicator of the magnitude of the needed restructuring. Assuming minimal changes, the share of net investment would go down, say, from 30 to 15%, while the share of military expenditures would be reduced from 20 to 10%; there would be a need to convert one quarter of the economy. That is, at least 25% of Soviet employees would have to change jobs. Yet, there was another way to look at this extremely high share of investment and defence expenditure. It was also a vast potential reserve. It could later provide the necessary funds to repay the debt.

Needless to say, there was no sense in proceeding with foreign borrowing without decisive measures to implement radical changes. If the new market economy were not created, the old system would have probably swallowed all foreign credits without any increase in output. In other words, the whole program, consisting of these three sets of measures, was designed as a package. If that had been implemented, it would have been by far the best and most elegant scenario of perestroika. Yet, this scenario failed to materialize. Radical reforms were never carried out, partly because the government itself chose the strategy of gradual reforms and partly due to bureaucratic resistance, which impeded the implementation of even those laws and regulations approved by the government.

It may be argued that perestroika was not started by the Party, as Party officials usually claim, but rather by Gorbachev. Without Gorbachev's initiative, the old system could have easily survived another 10 to 20 years without any serious danger of unrest. Until 1989, when the new Supreme Soviet was elected, there was one major power center, the Politburo, and the decision-making process was largely dominated by high Party officials. Thus, perhaps radical economic reforms were simply not politically feasible at that time, pushing Gorbachev to proceed with political reforms. However, this is still a very controversial issue. Klyamkin and Migranyan suggested in August 1989 that authoritarian rule, rather than democratic, might be a preferable political regime for the implementation of economic reforms during the transi-

tion.⁷ Nevertheless, the majority of intellectuals tend to think that democratic reform was a prerequisite for market-type reforms. Otherwise, reform-minded leaders, such as Gorbachev, would not have had enough power to start truly radical reforms.

One way or another the transition to the market was delayed. At the same time, virtually nothing was done to create appropriate mechanisms of market regulation. Probably worst of all, during 1985–1990 the government financed budget deficits by printing money, nearly destroying the consumer market. Eventually in 1989 the government found itself in a position where major economic reforms had not yet started, but the initial conditions for reforms had seriously deteriorated. The government budget deficit had considerably increased, as had internal and external debt. The monetary overhang had become huge and inflation had accelerated. The partial dismantling of the old system of administrative planning resulted in distortions and the weakening of work discipline, so production virtually ceased to grow and living standards fell.⁸

2. HOW TO FINANCE RESTRUCTURING

Given the urgent need to pay for the increased costs of perestroika, the government faced several options entering 1990. It is useful to discuss these options in terms of different ways of financing the government budget deficit, which in the late 1980s grew to more than 10% of GNP. The increase in the deficit came partly from exogenous factors such as the slump in oil prices, partly from the deterioration of the economy, and partly from mistakes in policy. Yet, provided there was an increasing budget deficit, the most evident mistake was the financing of the deficit by printing banknotes. This resulted in a tremendous monetary overhang and shortages in the consumer market, so that the issue of finding noninflationary ways of financing the deficit became urgent. The following are some basic options that were considered.

a. Redistribution from Investment to Consumption

The idea originated from the plans of conversion of the defence industry, debated first in 1988, when Gorbachev announced unilateral cuts in the military. At the same time, some large-scale investment projects came under severe public criticism. Later, the whole idea materialized in the 1990 economic plan, worked out by the government and approved by the Congress of

⁷ *Literaturnaya Gazeta*, Aug. 16, 1989.

⁸ See, for instance, "Soviet Economy Stumbles Badly in 1989." *Izvestia*, 30, July 19, 1990.

People's Deputies in December 1989. The plan envisaged reducing government investment in material production by 25%, cutting imports of investment goods, and reducing the share of investment in national income from 16 to 14%. The plan also envisaged a transfer of 15 billion rubles from industrial construction to housing construction and current consumption within one year.⁹

At first sight, this plan seemed perfectly logical, since the Soviet accumulation fund is inflated. However, reconversion of any industry in any economy always poses problems. One should remember that in the United States, military reconversion after World War II was accompanied by reduced overall industrial output for two years running. In 1946, United States manufacturing produced 25% less output than in 1944. One should also keep in mind that in a command economy any structural change would be more costly than in a market economy. Recent Soviet experience in converting wine and vodka distilleries into factories for soft drinks is indicative. The total output of alcoholic beverages, soft drinks, juices, and mineral water fell until 1987 and had not even reached the 1984 level by the end of the 1980s.¹⁰

For six decades running the Soviet economy had a significantly higher accumulation rate than that currently planned. Why does one suppose that a single decree would suffice to change everything overnight? If the output of the means of production had for decades grown more rapidly than that of consumer goods, would it be realistic to plan a 13-fold higher growth rate for consumer goods than for the mean of production for 1990?¹¹ The planned transfer of resources to consumer goods and housing construction may end only in shortages of raw materials, energy, and equipment for consumer production. Consequently, the output of consumer goods would ultimately decrease owing to the need for higher investment to liquidate emerging bottlenecks.

It is true that the Soviet economy is suffocating from excessively high investments, which should be cut. But this cut could and should naturally happen in the transition to the market, since the market mechanism for allocating resources would be more efficient than that of a command economy. To hasten events by issuing orders from above would ruin the whole undertaking. Compulsory cuts in investment in favor of consumption could lead only to a break in existing economic ties, misalignment, chaos, and, in the end, economic recession.

b. Increase of Consumer Goods Prices

Food, especially meat and milk, is heavily subsidized in the Soviet Union, and the government could save up to 100 billion rubles by eliminating these

⁹ *Izvestia*, Sept. 26, 1990.

¹⁰ *Narodnoye Khozyaistvo SSSR*, various years.

¹¹ *Narodnoye Khozyaistvo SSSR*, various years; *Izvestia*, Sept. 26, 1990.

subsidies. The issue was widely discussed from the beginning of perestroika, but the discussion revealed that virtually everybody is against price increases even if they are accompanied by direct money compensation.¹² Hence, in early 1989, the government promised that prices for basic consumer goods would remain unchanged for the next two or three years. In fact, in November 1989 Gorbachev even went so far as to state that an unregulated market, if allowed, "in two weeks will force the people to get into the streets and will wipe out any government."¹³ This was clearly a reference to the impossibility of the deregulation of prices for basic consumer goods.

Although the majority of academic economists several years ago were against consumer price increases, there were always some who favored immediate deregulation of all prices. In the fall of 1989, the all-union Supreme Soviet voted against proposed price increases for cigarettes, alcoholic beverages, and some consumer luxury goods, though the Estonian parliament approved such increases. This could be a sign that egalitarian feelings are not as strong in Estonia as in Russia and other areas, so that people in the Baltics tend to be more willing to accept equilibrium prices while in other less wealthy regions people would prefer rationing.

In May 1990, the government declared a program for price increases for all goods starting on January 1, 1991. The proposal was to increase retail prices to bring in extra annual revenues of 200 billion rubles, providing simultaneously a 135-billion-ruble annual compensation to consumers. This implied doubling food prices and price increases for nonfood consumer goods and services in the range of 20 to 70%. It was also suggested that bread prices should be increased immediately, starting from July 1, 1990, with full compensation to consumers. But the Supreme Soviet did not support the program. The proposal to increase bread prices was voted down. The other proposals were heavily criticized with a final verdict that they should be redesigned and brought back to the Supreme Soviet for reconsideration. It is difficult to say to what extent the government proposals were turned down because of the egalitarian feelings of the deputies, reflecting the feelings of voters, and to what extent they were driven by the understanding that market-type reforms should deregulate prices rather than have them set in a bureaucratic game. In fact, both types of arguments were used during the debates. In the beginning of 1990, the idea of price increases was supported by a definite minority, mostly wealthy individuals. Now it is quite probable that most people would be willing to accept price deregulation for most consumer goods together with rationing of some basic foodstuffs. A poll, conducted in Moscow in July 1990, revealed that 45% of the respondents

¹² See, for instance, *Literaturnaya Gazeta*, Aug. 12, 1987; Jan. 20, 1988; Sept. 14, 1988.

¹³ *Pravda*, Nov. 6, 1989.

preferred rationing, 27% free market prices, 7% so-called social money, where part of a salary would be paid in certificates that could be used only to buy low-priced goods in state shops, and 5% price increases with compensation as in the government program.¹⁴ It is worth noting that, among those who favored rationing, there was a higher percentage of individuals with lower educational levels and social status.

c. Monetary Reform

One proposal was to exchange the old currency for a new one, up to a certain amount at a ratio of 1:1 and after that at a ratio of 1:10.¹⁵ Monetary reform was until recently advocated by the extreme right wing, those associated with trade unions, the United Front of Workers, and the organization called "Pamyat."¹⁶ They claimed that perestroika is restoring capitalism, that the underground economy is gaining power, and that the cooperatives are producing new millionaires linked to illegal activity. But, in late 1989, Gavril Popov and Boris Yeltsin, two of the leaders of the left side of the political spectrum, gave their support to monetary reform.¹⁷ Shortly afterward they abandoned the idea, which was unpopular among intellectuals and new entrepreneurs.

Advocates of monetary reform claim that 99% of the population support it. A rightist economist, A. Sergeev, accused Yeltsin and Popov of stealing the idea from the rightists and claimed that this idea does not fit into the leftist program but is popular with the masses.¹⁸ Yet, most radical economists strongly oppose monetary reform. Recently published data reveal that out of 300 billion rubles of demand and savings deposits in the beginning of 1989, those accounts, some 2.2 million, that exceed 10,000 rubles total only 30 billion rubles.¹⁹ Hence, the government will gain just 30 billion rubles even if it decides to confiscate all savings in excess of 10,000 rubles. By doing so, the leadership will lose the confidence of the Soviet middle class, the major driving force of perestroika. The confidence of this middle class, as well as the beliefs among all that property rights should not be violated, costs more than 30 billion.

¹⁴ And 16% have no definite opinion (*Izvestia*, July 23, 1990).

¹⁵ Or, alternatively, also at a ratio of 1:1, provided that an individual could prove that his money was earned in a legal way.

¹⁶ *Literaturnaya Rossiya*, Feb. 9, 1990.

¹⁷ *Argumenti i Fakti*, No. 8, 1990.

¹⁸ *Literaturnaya Rossiya*, Jan. 12, 1990.

¹⁹ *Finansi SSSR*, za 1988 god, p. 40, 1989.

d. Increase in Government Domestic Borrowing

This may look like a positive development, as the value of government bonds held by the population is negligible.²⁰ Until recently, enterprises, cooperatives, and organizations did not hold government bonds at all and the volume of newly issued bonds purchased by individuals in recent years amounted only to 1–2 billion rubles.²¹ This step may help to ease the monetary overhang and to convert forced savings into voluntary savings, provided that the interest rate is high enough.

In 1990 the government intended to offer individuals 5% bonds totaling 15 billion rubles and commodity bonds giving the right to buy goods in short supply for 10 billion rubles. Also, it would offer 5% bonds totaling 60 billion rubles to enterprises, co-ops, organizations, and banks. This would still leave the government with the need to print 10 billion rubles of new money, down from 18 billion in 1989.²² In fact, by the autumn of 1990 the bonds had still not been sold and money emission for the first seven months of the year totaled nearly 11 billion rubles.²³

e. Selling and Leasing Tangible Government Assets

State property is enormous, and there are persons and companies willing to buy or rent it, and there will evidently be more such requests as market relations develop. The constraint is, however, that there is still no private ownership of land and until recently individuals could not own production operations larger than a family business. The Land Act, approved by the Supreme Soviet in February 1990, to go into effect March 15, allows farmers to lease land with lifetime tenure, not ownership, and the possibility of inheritance. Nevertheless, it is prohibited to sell plots of land and to use them as collateral. The Law on Property of March 1990, in effect as of July 1, allows private ownership of small enterprises for family members and "other persons, jointly operating labor based business." In July 1990, however, the government prepared a decree allowing small private businesses, up to 200 employees in industry. In June 1990, a government decree allowed the transformation of state enterprises into shareholding companies with possible buyout of part of the shares by individuals and other companies.

The population is still suspicious of private property. In a February 1990 poll, although 47% supported the idea of private enterprises and 15% were against it, 42% were against the right to hire employees, 12% stated that this

²⁰ *Pravda*, Oct. 28, 1988; *Dengi i Credit*, 7:7, 1988.

²¹ *Narodnoye Khozyastvo SSSR*.

²² *Pravda*, Nov. 11, 1989.

²³ *Ekonomika i zhizn*, no. 4, 1990.

right should be limited to a small number, say, 10 employees, 13% stated that employment should be limited to a larger number, and only 13% stated that private enterprises should hire without restriction.²⁴ In another poll, also conducted in February 1990, although 85–87% supported individual use, not ownership, of land and 10% were against it, 50% were against granting the right to sell and buy land and to hire employees. Only 10–14% of peasants wanted to be independent farmers, 40% wished to have individual plots, 30–33% wanted land, but were afraid that it would be taken back, and 10% did not want to own land.²⁵

Party bureaucrats take an especially hard stand on the issue of private farming: 73% of the delegates, nearly half of them professional party bureaucrats, to the XXVIII Congress of the Communist Party, held in July 1990, were against selling land to private persons. The overwhelming majority argued that collective and state farms have the best prospects, while only 12% associated these prospects with independent farms. In contrast, 24% of the population regards independent farms as the agricultural unit with the best prospects.²⁶ The newly formed, June 1990, Peasant's Union, where the directors of state and collective farms dominate, considers independent farming a supplementary form of agricultural organization that should never become dominant. The Union pushes strongly for increased investment in collective and state farms, arguing that this is the best way to improve productivity.²⁷

f. Inflow of Foreign Direct Investment

This inflow would be ideal to finance restructuring. It would provide badly needed foreign currency and potentially could be very large. However, currently there are many obstacles for foreign investors. After joint ventures were allowed in January 1987, some 2000 joint ventures were established with \$2 billion in foreign direct investment. In 1989 these joint ventures produced goods and services for 1 billion rubles and in 1990 for 2 billion.²⁸ This is still a very small amount. The reasons for this are bureaucratic red tape, difficulties with supply, lack of guaranties for safe operations and profit transfers, an unstable investment climate, and, most important of all, inconvertibility of the ruble. Although the Shatalin 500-day program envisaged convertibility by the end of 1991, the government has no time schedule for

²⁴ *Izvestia*, Feb. 26, 1990.

²⁵ *Izvestia*, Feb. 28, 1990.

²⁶ *Izvestia*, July 6, 1990.

²⁷ *Izvestia*, June 12, 13, 1990.

²⁸ *Izvestia*, Aug. 20, 1990. The figure for 1990 is an estimate.

convertibility. Moreover, the rightists are trying to prevent even the leasing of land to joint ventures, considering this as a selling out of the motherland.

g. Increase in Foreign Borrowing

As in earlier years, this means of raising funds is attractive. However, the ability to borrow has deteriorated; the USSR is now considered a risky borrower. The 1989 miners' strikes, followed by increased national tensions and unrest, created doubts among Western creditors concerning the ability of the Soviet leadership to control the maelstrom of events. Payment difficulties at the end of 1989 undermined credit worthiness even more. By midyear 1990, the Soviet Union's delays in payments for imports totaled several hundreds of millions of dollars and gold was being used as a collateral for \$3 billion worth of credits.²⁹ Meanwhile, the need for external funds increased. In September 1990, Prime Minister Ryzhkov stated that hard currency revenues in 1991, after the 12.5 billion rubles needed to service the debt are subtracted, will allow the Soviet Union to buy only one-third of the imports bought in 1990.³⁰

Until midyear 1990, the government was not willing to increase foreign borrowing, claiming that people would not accept it. In June 1990 Deputy Prime Minister and Chairman of the Commission on Economic Reform L. Abalkin stated: ". . . The price of concessions that we may be demanded to make [in exchange for assistance] is high enough. . . . The existence of two [social] systems is not an ideological myth, but a reality. If this issue would be decided at a referendum, I have strong doubts about a positive reaction. I know that anti-market feelings are quite spread in this country and if all these conversations about 'selling out the motherland' would be added to these feelings, the people would hardly accept such an option. . . . We must rely mostly on ourselves."³¹ Nevertheless a month later Gorbachev sent a letter to President Bush asking for "assistance with credits, that may help the reforms."³² Still, even in September 1990 Ryzhkov, presenting the government program to the Supreme Soviet, denied the possibility of foreign assistance.³³ In contrast, the alternative program, prepared by the democratic opposition, Shatalin's group, called for starting negotiations with major Western countries and international organizations immediately. The pro-

²⁹ *Wall Street Journal*, June 4, 1990.

³⁰ *Izvestia*, Sept. 11, 1990.

³¹ *Literaturnaya Gazeta*, June 6, 1990.

³² *Izvestia*, July 9, 1990.

³³ *Izvestia*, Sept. 11, 1990.

gram saw the negotiations as leading to a new Marshall Plan.³⁴ Ten to twenty billion dollars was mentioned in Shatalin's program as a possible amount of Western financial assistance and Nikolai Petrakov, Gorbachev's economic adviser, was speaking in October 1990 about \$10–12 billion at least.³⁵

3. RECENT DEVELOPMENTS AND FUTURE OPTIONS

The March 1990 elections to the Russian Supreme Soviet, other republican legislatures, and local Soviets created a new political situation. In Russia, the democratic bloc got more than one-quarter of the seats in the new Supreme Soviet and Yeltsin was elected as Chairman. In Moscow, Leningrad, and other major cities, democrats were elected as mayors and in other republics and local Soviets they considerably strengthened their position. From then on, there developed a schism between more radical-minded republican governments and local authorities, on the one hand, and the conservative central government, on the other hand. This new situation pressured the central government, as the republican governments and local authorities began to seek greater power and independence, to implement radical reforms.

At the same time, the idea that radical restructuring would inevitably be accompanied by a considerable temporary reduction of living standards began to penetrate the public consciousness. The government program submitted to the Supreme Soviet in May 1990 envisaged two scenarios: the first one, labeled shock therapy, implied immediate deregulation of major prices, while the second one was based on less restrictive monetary policy and gradual, rather than immediate, elimination of price controls. According to the first scenario, GNP would fall by 10–15% in 1991, but increase afterward to 144–150% of the 1990 prereform level by 1995; employment was scheduled to fall by 5–7% in 1991, investment by 50%, and real incomes by 4–7%. The second scenario envisaged a smaller slump in 1991: reduction of GNP by 5–9%, employment by 3–5%, investment by 14–19%, and real incomes by 1–3%. But it also predicted a slower pace of recovery after 1991—only a 25 to 35% increase in GNP by 1995, compared to the 1990 level.³⁶ Presenting the program to the Supreme Soviet in May 1990, Prime Minister Ryzhkov said that the first option, was not socially acceptable, so the government asked the deputies to support the second option. Nevertheless, the Supreme

³⁴ "Perekhod k Rynku. Kontseptsiya i Programma." Working Group, created by a joint decision of M. S. Gorbachev and B. N. Yeltsin, p. 132, Moscow, Aug. 1990.

³⁵ *Za rubezhom*, no. 42, 1990.

³⁶ *Economica i zchizn*, no. 28, 1990.

Soviet considered the second option inappropriate. Pavel Bunich, a radical economist, called it "a shock without a therapy."³⁷

By September 1990, the options for financing restructuring coalesced into two distinct programs, put forward by radicals (democrats) and conservatives (bureaucrats). The first program, the so-called 500 days, was prepared by a group headed by Shatalin and created by a joint decision of Gorbachev and Yeltsin. The second was designed by the government and was just a modified version of the government program that had failed to get the support of the Supreme Soviet in May 1990.

Shatalin's program was a plan for radical market-type reforms. It envisaged decisive measures for financial stabilization, rapid dismantling of central planning, radical agrarian reform, creation of a market infrastructure, borrowing abroad, and other ways of obtaining foreign currency to finance the transition.³⁸ Most important, Shatalin's program was supported by most, if not all, of the republics, as it envisaged considerable decentralization of economic power. Hence, it provided a real chance to preserve the all-union monetary system and to avoid the disintegration of the emerging Soviet market.

The government program presented in September 1990 was more radical on privatization than the one submitted in May, but nevertheless it was based on the old approach to price reform, administrative manipulations instead of deregulation. To put it differently, the Ryzhkov program still did not envisage the creation of a market economy, as there can be no market with fixed prices. This is despite the fact that the government recognized that if no measures were taken industrial output and national income would decrease in 1991 by 15% and investment in material production by 35%.³⁹

The immediate implementation of Shatalin's program, scheduled in the program itself for October 1, 1990, was the best option, as it allowed for rapid shock therapy treatment of the economy on the basis of a consensus between republics. In this way it was possible to ensure that the rules for restructuring would not be changed constantly, misleading enterprises and individuals. This is not to say that Shatalin's program did not have costs. One must take with extreme caution the predictions of the program itself: an unspecified temporary reduction of output, an increase in the unemployment rate from 4 to 8%, and the stabilization of living standards during the transition period.⁴⁰ This was just wishful thinking. Government estimates that the imple-

³⁷ *Izvestia*, May 28, 1990.

³⁸ *Perekhod k Rynku. Konceptsiya i Programma*. Working group created by a joint decision of M. S. Gorbachev and B. N. Yeltsin, Moscow, 1990.

³⁹ *Izvestia*, Sept. 11, 1990.

⁴⁰ *Perekhod k Rynku. Konceptsiya i Programma*, pp. 53, 57, 99, 111.

mentation of Shatalin's program might lead to a 30% or more reduction of living standards may be closer to reality.⁴¹

Unfortunately, Shatalin's plan was not carried out. Gorbachev backed a combination of Shatalin's and Ryzhkov's plans, which was approved by the Supreme Soviet in October 1990. This forced the republics to abandon the idea of economic compromise. Russia and many other republics stated their intentions to pursue 500-day or similar plans. The Ukraine introduced a sort of republican consumer money in the beginning of November 1990. With similar steps from other republics, the Balkanization of the Soviet economy was exacerbated. There is no more hope for joint and coordinated efforts of the republics and central authorities to ensure radical market-type reforms.

There may be some chances for a second-best option, the gradual transition by presidential decree without a major clash between central, republican, and regional authorities. This scenario implies that either republican governments will hold back their demands for greater economic independence or the central authorities will somehow ensure that regions and republics do not pursue economic separatism. The chances for this second-best option worsen as time passes and the republics one by one opt for full economic independence to implement radical reforms.

Finally, there is a third scenario, economic disintegration of the Union, emergence of many different markets separated by their own currencies, custom duties, and other trade barriers. The costs of this scenario are obvious: the central government, republics, and regions will fight over the distribution of economic power and this fight is likely to absorb their time, efforts, and energy. Introducing separate currencies and trade barriers will cause an expensive restructuring of existing interregional trade flows. Prospects for Western financial assistance, direct investment, and credits will become more uncertain.

Unfortunately, one may now observe events developing along the lines of the third scenario. The President is unwilling or unable to accept the ultimatum of the democratic bloc to change the government and to accept Shatalin's program, while the democrats are not prepared to compromise with the President by supporting his program. The paradox is that the democrats, that is, republican and regional authorities highly influenced by the democrats, pushing strongly in favor of the first-best option actually speed up development along the lines of the third, most painful, scenario.

4. APPLYING PUBLIC CHOICE THEORY

As a society currently making a transition from authoritarian to democratic rule, the Soviet Union may be of interest to public choice theorists in

⁴¹ *Izvestia*, Sept. 11, 1990.

two respects. First, Soviet political processes offer numerous examples of purely bureaucratic decision making. Second, to the extent that democratization is taking place, there are reasons to believe that conventional techniques of public choice theory may be applicable. In a similar way, public choice theory is of interest to Soviet economists and political scientists.

In fact, Soviet analysts have paid increasing attention to decision-making processes as a consequence of electoral reforms and changes in the political system. Many observers were surprised to realize that democratically elected bodies often make decisions that are far from Pareto optimal. It may be of interest that there are some direct references to public choice in the debate on decision making in the Soviet Union. For example, while explaining the extraordinary power enjoyed by branch ministries and regional authorities in opposing structural shifts that do not benefit them, Gaydar (1990, p. 121) refers to Olson's findings that small but well-organized groups, such as industry associations and regional coalitions, may have greater influence than large but less-organized groups, such as consumers, taxpayers, and the unemployed. Also, Osadchaya (1990) argues for the relevance to socialist society of Buchanan's reasoning that the government sector in a democratic society may well be larger than necessary for economic efficiency, due to political groups and the bureaucracy's interests.

Normative implications of public choice theory may have even greater significance for the restructuring of the Soviet political system. Today, this system is extremely complex but it is changing all the time. Different political groups favor changes in different directions. The leftist Interregional Group fought to abolish Article 6 of the Constitution, establishing the leading role of the Communist Party, and now opposes the procedure of elections of deputies by social and interest groups. But the United Front of Workers vigorously promotes a corporative electoral system, in which deputies are elected from enterprises and organizations, not from territorial districts. The radicals claim that such a corporative democracy, in which voters express their preferences not like citizens, but rather like producers, will effectively stop the reform process as deputies will represent not citizens', but rather producers' interest groups.⁴²

There was also a proposal to introduce, at least as an experiment, a sort of point-voting system, with voters defining their quantitative preference for each candidate or ranking them so that nobody votes against candidates, resulting in a democracy without opposition. Unfortunately, it seems that the proposal failed to attract much notice, though the authors argued that

⁴² *Izvestia*, Oct. 25, 1989.

such a system is more suited for socialist democracy than simple majority rule.⁴³

Yet, there may also be difficulties in applying public choice to today's Soviet political process. One of these difficulties, resulting from the fact that democratization began quite recently, is that democratic traditions are not very strong. People often lack the necessary political culture as they are just learning to live in a new democratic environment. Declarations of sovereignty and independence issued not only by nearly all republics, but also by small and large communities in these republics, are quite meaningful in this respect.

Given these realities, one cannot expect that most people have appropriate knowledge and experience for choosing the right strategy during elections, for finding the optimal, from their own point of view, solutions to national problems. Indeed, one may assume that, given little democratic experience and a heavy burden of past psychological stereotypes, it would be difficult for people to compare short- and long-term consequences of proposed policy changes. Born and raised in a society in which nearly everything was decided by the leadership, many Soviet citizens are quite unprepared to evaluate the costs and benefits of their votes, not only for everybody but for themselves as well.

This may sound like a very undemocratic statement, as it is usually believed that the electorate as a whole is smarter than any single voter, yet it is true. There are many examples in Soviet and non-Soviet history when majority decisions were not only suboptimal and bad for others, but also harmful for the majority. In fact, the statement "the majority is not always right" is frequently used in the Soviet Union these days.

The argument may seem to fall in line with the rational ignorance phenomenon of public choice (Mueller, 1989), but it is not exactly so. Rational ignorance implies that voters, realizing that their own vote will not be decisive, simply opt not to waste time studying an issue in detail. This was certainly true in the Soviet Union prior to glasnost. In contrast, voters are now much more interested in politics, in part because of the belief that their vote will make a difference. The problem is that their knowledge of the basic mechanisms of centrally planned and market-oriented economies is still rather limited, though increasing very rapidly, and still strongly influenced by past stereotypes. Their perceptions about, say, private property do not allow them to choose optimally. Consider, for example, the widely debated issue of cooperatives, which are now a substitute for private entrepreneurship. As polls indicate, the majority of the population does not have a favor-

⁴³ *Moskovskiy Novosti*, Feb. 5, 1989.

able opinion of cooperatives. One of the recent polls revealed that only 15% evaluated cooperative activity positively, while 29% reacted negatively, and 56% had mixed feelings or were unsure.⁴⁴ Only in three Republics, Estonia, Armenia, Latvia, did the number of proco-op respondents exceed that of antio-op respondents.

High prices, low quality, unreasonably high incomes, illegal activities, and links to the underground economy—all these bad things accompanied the development of the cooperative movement. However, they result not from the idea itself, but from miscalculations in the implementation of the idea, because co-ops are often monopolies, because state enterprises often do not have the same freedom of operation, and because it is easy to profiteer from shortages. Still, many people are against the idea itself. The trade unions and the United Front of Workers demand strict price controls on cooperative goods and the banning of some cooperative activities. In the fall of 1989, the Supreme Soviet narrowly failed to prohibit all trading by co-ops. The argument that most are better off with co-ops simply does not work, as people are often led not by rational considerations but by emotions, being blinded by envy of high incomes.

Monetary reform may be another example of the inability to account fully for the long-term consequences of decisions. Gaining only 100 rubles per capita once, less than half of an average monthly wage, even with a very radical scenario for such reform, the majority of the population will lose more as the discouragement of the middle class slows growth. Still, the idea is very popular. Price reform is similar. Although it is evident that subsidizing meat and milk is a nonoptimal and unjust way to distribute government subsidies since fewer subsidies go to relatively poor families, the majority is against price increases even if they are accompanied by money compensation outweighing the losses.

According to a poll conducted midyear 1990, 46% of respondents thought that apartment space should be distributed absolutely equally; 16% of respondents answered that they also support equality, but that those with special privileges should have certain advantages; and only 24% suggested that living space should depend only on ability to pay, while the government should provide allowances to low-income families.⁴⁵ Here again, as in the case of meat and milk, the major part of subsidies goes to relatively wealthy families. In other words, price subsidies are mainly associated not with the pressure of interest groups or with the activity of bureaucrats, as would be suggested by conventional public choice analysis, but with the egalitarian

⁴⁴ *Ekonomika i zhizn*, no. 2, 1990. The poll had 100,000 respondents.

⁴⁵ *Literaturnaya Gazeta*, June 6, 1990.

feelings of individuals, which determine the appropriate behavior of politicians.

Briefly speaking, one of the major difficulties in applying public choice to recent Soviet experience may be the large uncertainties about the motives that determine voter behavior. The same kind of difficulties clearly exist in Western countries. In elections, people do not always behave only in their own self-interest. As survey evidence indicates, beneficiaries of government growth do not have significantly different preferences for tax limitation proposals than other voters. Moreover, "even tenured economics professors may vote in favor of unemployment compensation programs" (Mueller, 1989). Still, one may argue that in Western countries, voter behavior is determined by some stable perceptions and images about the ideal world in which they would like to live. Welfare recipients may be fully aware of the fact that large-scale income redistribution, leading to greater income equality, may undermine economic efficiency and growth, resulting finally in a reduction of welfare payments. Tenured economics professors may regard unemployment insurance as an integral part of a socially just world in which they wish to live.

It is the opposite in the Soviet Union, where there is still no consensus that the market is the most efficient way to organize the economy and that the violation of property rights is not only immoral but also leads to long-term costs that outweigh short-term benefits. Besides, perceptions and preferences of voters are unstable and shaky, changing surprisingly quickly in the glasnost atmosphere. The same argument might be put in a different way. Voters can be viewed not as absolutely selfish individuals, but as people with some behavioral psychology and some ethical preferences (Mueller, 1989). Simplifying, it is the ethical preference of an average Soviet voter to emphasize egalitarian income and wealth distribution, collective responsibility, guaranteed incomes, etc. In contrast, the average Western voter has a greater respect for personal freedom and property rights.⁴⁶

Yet, the basic argument of this paper is not so straightforward. Even given these egalitarian feelings, the behavior of a typical Soviet voter looks irrational, because he does not realize, due to ideological stereotypes, that a radical

⁴⁶ Klyamkin (1987) even goes as far as to state that Soviet peasants accepted Stalin's collectivization because they never had the psychology of West European or American farmers. These peasants were used to sharing responsibility in the agricultural community (*obschina*), which existed in Russia for more than a thousand years. This statement rests on two factual mistakes: first, peasants never accepted collectivization; it was imposed by force. Second, a mixed system of land ownership, dominant before 1917, was very different from the *kholkoz*es that emerged in 1929–1933. In the old community, peasants enjoyed personal freedom and owned land and the means of production, while in the *kholkoz*es they were deprived of all these rights (Popov and Shmelev, 1990).

move to the market may result not only in higher incomes, but also in an acceptable level of income inequality. His perceptions about the market are wrong and, together with egalitarian feelings, this may be the major factor making for nonoptimal decision making. Under such conditions, mistakes in government decisions may result not just from a failure of emerging democratic bodies and institutions to elaborate appropriate policy. There is also the inability of voters to determine what policy measures would best serve their interests. Policy choices may be far from optimal not only because something is wrong in the political mechanism but also because citizens' knowledge is very incomplete.

In the first four years of perestroika (1985–1989), power was held by high Party bureaucrats; public opinion, voter pressure, and interest groups were not major forces. It may be that in this period the authoritarian nature of the political system was the main obstacle to finding optimal solutions and to the implementation of radical market reforms. While some liberal Party leaders were in favor of such reforms, they were not strong enough to fight the opposition of other Party leaders. It may also be that at this time there was a compromise between liberals and conservatives in the Party leadership. While the latter made some concessions to the former in the field of external and military policy, they obtained in exchange for these concessions a promise not to push hard for economic reforms.

In 1989–1990, the whole political environment changed, as new institutions appeared. The Congress of People's Deputies and the Supreme Soviet were newly elected in March 1989 and republican and regional authorities at the end of 1989 and beginning of 1990. These emerged as new power centers with a more leftist political orientation. The Rubicon was crossed, probably, in December 1989, when the Second Congress of People's Deputies voted to abolish Article 6 of the Constitution, which guaranteed the leading role of the Communist Party. This, and the March 1990 elections to republican and local Soviets in Russia, meant that individuals influenced decision making through conventional democratic institutions and that policy no longer depended completely on Party intrigues. Unfortunately, after eliminating one factor of nonoptimal decision making, authoritarian rule, the government finds itself considerably constrained by another factor, egalitarian feelings and voters' stereotypes.

The pessimistic conclusion to be derived is that optimal solutions are unlikely to be found for economic reforms. The history of perestroika now looks like the history of missed opportunities. We have already missed the chance of adopting a low-cost scenario in the early years of perestroika. In 1989–1990, an administrative approach to economic restructuring was adopted, which must be regarded as nonoptimal. Another chance was missed in September 1990 in the failure to approve Shatalin's program. This

increased the future costs of restructuring and opened to the full extent the Pandora's box of disputes between the central government and republics. Unfortunately these kinds of mistakes may not be completely avoided in the future. However, there is also an optimistic conclusion. Public consciousness is currently making very rapid progress, as people realize that their recent perceptions were wrong. Hence, sooner or later there will be one less factor contributing to government failure in the Soviet Union.

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