THE TRANSITION TO A MARKET ECONOMY IN RUSSIA: PROPERTY RIGHTS, MASS PRIVATIZATION AND STABILIZATION[1]

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The problem of how to transform a centrally planned economy into a market economy has emerged as one of the most compelling and challenging issues of our time. The question is salient because the republics of the former Soviet Union and the nations of Eastern and Central Europe are in the midst of a transformation process that seeks to capture the claimed efficiency advantages of market mechanisms for their economies. It is complex because a rapid transition from socialism to a market economy is historically unprecedented and requires a fundamental restructuring of a nation's economic, political, social and legal institutions as well as its physical infrastructure. Not surprisingly, there are differences of opinion concerning the scope of reforms and the speed with which they should be undertaken. Murrell (1990) suggests, "that slowness of transition might be a virtue." An evolutionary path of transition is justified on the grounds that rapid and radical adjustments are likely to cause major short run disruptions while yielding only modest offsetting benefits. According to this view, a program of gradual reforms is more likely to produce a stable transition by maximizing the flow of output over the entire transition period. At the other extreme is Erickson's (1991) claim that reforms must be "trenchantly negative" and "disruptive on a historically unprecedented scale." This revolutionary view acknowledges that the rapid displacement of an entire system of inter-dependent central planning institutions inevitably causes painful economic disruptions. But unless these severe costs are borne in the short run, the entrenched structure of the centrally planned system will not be overturned, and the reform process will remain susceptible to reversal. To assure the irreversibility of reforms, the old system of central planning must be scrapped and replaced by a new system of legal, administrative, commercial, social security, fiscal and monetary institutions capable of supporting a market economy.

[1] The paper originally presented at the Law and Society Meetings in Amsterdam in June, 1991 has been updated to include a discussion of the reforms adopted by the Russian government after the dissolution of the Soviet Union.

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Most economists now agree that an appropriate transformation program must combine elements of stabilization, privatization and liberalization. In theory, each of these reform components reinforces the other, and therefore they should ideally be introduced simultaneously in one "big bang" reform. However, private property rights must be created, distributed and credibly enforced before exchange in these rights can take place in markets. Since the efficiency of exchange is greatly enhanced when exchange is conducted in a stable macroeconomic environment, privatization and stabilization should typically precede liberalization reforms. In practice, it has proved impossible to initiate a “big bang" reform strategy. The time and practical difficulty of implementing privatization and stabilization measures has forced governments liberalize first and only then to undertake stabilization and privatization initiatives. The improper sequencing of reforms is likely to have a significant impact on the stability of the transition to a market economy.

As conceptual reform strategies are put into practice, however imperfectly, the costs of rapid structural adjustment become more visible and widespread. The threat of closure of large state enterprises and the experience of unemployment and hyperinflation produce a political backlash against the advocates of rapid and radical reform. The realization grows that simple prescriptions for transplanting market mechanisms into formerly planned economies are unlikely to succeed unless the institutional prerequisites for a market economy are securely in place. These legal, commercial and administrative institutional precursors of market economies took generations to evolve historically, and cannot be readily created de novo. Long-standing expectations and behaviors generated by regimes of central planning are difficult to change. The time required to establish the credibility of a reform program as well as the institutions required to assure its success may well exceed the political horizon allotted to reform leaders.

There remains an enormous gap between transition theory and practice. The theory of reforms is continuously being reassessed in the light of experience with the actual reform programs. This paper examines the theory of reforms in light of the experience of the recent reforms that preceded and followed the dissolution of the Soviet Union. The first sections review the essential components of reform strategy concerning the nature, sequence and speed of the reform process. The paper goes on to describe the major political cycles that have characterized the reform process before, during and after the dissolution of the Soviet Union. The most radical reforms have only recently been initiated in Russia, but these reforms are already being seriously challenged. The Russian reforms now appear poised at a critical juncture, one that may well determine whether, and in what form, the transformation to a market economy will proceed.

The Conceptual Framework of Transitional Reform

Transformation strategies typically define the final objectives of reform and the nature, sequence and timing of reforms most likely to achieve the designated objectives. Reform objectives include stability; efficiency, equity and economic growth and these objectives are believed to be most readily attainable by the establishment of a market economy. To be successful, a transformation program must be comprehensive, coherent, credible and dynamically stable. A comprehensive program of reform must contain elements of stabilization, privatization and liberalization. To be coherent, these elements must be properly sequenced and mutually reinforcing. Credibility requires the consistent management of the reform program such that the expectations and commitments created by the reform plan are in fact fulfilled and thereby reinforced. The necessary, although not sufficient conditions required to satisfy a stable transition to a market economy include:

1) The creation and enforcement of an efficient system of property rights governing the ownership, use and exchange of real and financial assets over time and space and the distribution of state property to the public.
2) Fiscal and monetary institutions that promote macroeconomic stability.
3) Industrial reorganization to promote entry and exit; de-monopolization, and the conversion of military production to consumer oriented output.
4) Liberalization of economic activity that permits market determined prices to provide the information and incentive signals required to allocate factors, products and assets to their highest valued uses, including price linkages that permit integration with the world economy.
5) The creation of a social safety net to cushion the economic dislocation that is sure to accompany radical reforms.

In several earlier papers[3] I outlined a specific transformation strategy for the Soviet Union consisting of a sequenced set of stabilization, mass privatization and liberalization reforms.[4] This integrated program was designed to attain many of the aforementioned conditions for a stable transition from a command economy with a preponderance of state owned property to a market economy with private property. In brief, the transition strategy referred to as "socialist privatization" envisioned combining a massive egalitarian redistribution of the state's custodial assets to its citizens with monetary and fiscal stabilization as the prelude to a complete liberalization of the price mechanism.[5]

The effort to establish a market economy in an economic environment devoid of market

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[3] Feige (1990 a, b, c, and 1991).

[4] Liberalization involves both domestic and foreign components including price decontrols, currency convertibility and integration with the world economy.

[5] A summary and comparison of various privatization proposals suggested by Feige (1990b); Frydman and Rapaczynski (1991) ; Lipton and Sachs (1990) and Blanchard et.al. (1991) is found in Borenzstein and Kumar (1991).

institutions and a political environment overtly hostile to market activities presents a major challenge. The Soviet economy was organized by a huge central planning bureaucracy that controlled state property representing ninety five percent of all property. Soviet political ideology viewed "private property" as anathema and Soviet law dictated that many elementary market activities such as arbitrage were economic crimes subject to severe punishment (Feldbrugge ,1989). Under these extreme circumstances, the challenges of the transition from socialism required a radical program specifically designed to take account of the particular political, social and economic circumstances of the Soviet Union. The unprecedented scale of state property, the absence of asset markets for valuing the property, and the lack of private savings to acquire that property implied that conventional forms of privatization[6] were totally inadequate as a means of creating and distributing property rights.

The Critical Importance of Property Rights

The essence of every market economy is the exchange of rights to various forms of property, broadly understood to include goods and services as well as real and financial assets. The creation of a market economy is unthinkable in the absence of valued property rights. Property rights refer to the institutional arrangements that govern the ownership, use and disposal of property. The values of property rights are ultimately determined by their exclusivity in use and their transferability in exchange. When property rights are vaguely defined they have little value. When the transactions costs of exchanging property rights are very high, the rights themselves have little value. In the republics of the former Soviet Union, the exclusivity of property rights are at best vaguely defined because of the legal fiction of state ownership. It is therefore not surprising that the stock of capital is so poorly maintained that its productivity so rapidly diminished. In the absence of de jure ownership, use and transfer rights, the terms on which property can be used or transferred is arbitrarily set by state planners. De facto rights are distributed by the "privilege system". Under these circumstances, the "privileged" have a single incentive, namely to rapidly exploit their tentative de facto rights through rent seeking behaviors.

The absence of real property rights is largely responsible for the system's inefficiency in production and exchange and its poor maintenance of capital stocks and natural resource endowments. Exclusive rights to property create the incentives to utilize property efficiently. The right to own and exchange all forms of property avails the economic system the efficiency advantages of unfettered exchange. But efficiency also demands that exchange be conducted with relatively low transaction costs. A necessary condition for low transactions costs is the existence of

[6] Conventional privatization schemes rely on the public sales of state assets on an enterprise-by-enterprise basis. This is the type of privatization undertaken in the United Kingdom and in parts of Latin America.

credible monetary institutions capable of establishing a monetary medium of exchange with a stable value. Finally, if exchange is to be universal, the establishment and equitable distribution of valued property rights must be one of the principal cornerstones of any reform program. Property rights must be distributed to citizens and other legal entities in an orderly and transparent manner. These rights must include both exclusivity in use and transferability in exchange. Exclusivity must be established by the privatization of state assets while transferability must be assured by the establishment of a fully functioning monetary and payments system.

Privatization Mechanics

Socialist privatization calls for a constitutional grant of private property rights to all citizens and for the state to relinquish its stewardship of the means of production. The nation's real wealth is to be supplemented by the creation of financial assets capable of representing physical wealth in more fungible form. State enterprises are converted into joint stock companies whose shares convey title and property rights. State assets are redistributed in two stages; an open market sale of small scale state assets including apartments, shops, storefronts, land parcels, vehicles etc. and a large scale mass privatization in which as much as half of all existing state assets are freely and equitably distributed among the population in the form of "citizen's shares". Citizen shares, as distinct from vouchers,[7] are shares in a state holding company whose assets in turn consist of a bundled portfolio of equities in large state enterprises. A citizen share is analogous to a claim on a mutual fund portfolio representing a broadly based index fund such as the Standard and Poor 500 share index. Citizen shares represent a generalized residual ownership claim on the earnings of the pooled assets of large state enterprises.[8]

Mass privatization can take the direct form of a free distribution of citizen shares or the indirect form of distributing vouchers (privatization checks) to citizens who in turn convert them into specific forms of state property. The indirect use of vouchers is advantageous for the purpose of small-scale privatization at the local level. It effectively gives each citizen an economic vote in the election of small-scale state assets. Some knowledge concerning small scale asset choices is available to most citizens and therefore an equitable distribution of these economic voting rights is likely to result in a more equitable distribution of property rights. However, vouchers are entirely inappropriate for large-scale privatization. Voting rights can only be effectively utilized in combination with information concerning the values of alternative choices. When these values are

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[7] Voucher schemes distribute certificates which entitle the bearer the right to bid for and acquire property put up for privatization by the state. The voucher may have a specific nominal value such as the 10,000 ruble vouchers now being distributed in Russia, or a point value such as those distributed in Czechoslovakia.

[8] Financial assets permit ownership rights to be unbundled from use rights and therefore permit s the separation of ownership from control.

unknown, and perhaps unknowable[9] for the public at large, vouchers cannot effect efficient property distribution. When relevant information is only available to a privileged few, vouchers cannot effect an equitable distribution. A highly skewed information distribution will bring about a highly skewed property distribution even when votes (vouchers) are initially distributed equally.[10]

For large-scale privatization, the direct distribution of temporarily inconvertible citizen shares circumvents these problems. Distribution of these shares does not require valuation of the underlying equities. As reforms progress and asset markets are established, citizens can then exchange their citizen shares into shares of newly established private mutual funds. Mutual funds can acquire pools of citizen shares, which they would unbundle in order to specialize their own portfolios. Mutual funds would be expected to specialize their portfolios so as to achieve concentrations of ownership in particular enterprises. Institutionalized concentration of share ownership would provide additional incentives for efficient management of enterprise assets and production decisions.

Under the socialist privatization proposal, a portion (10%) of the bundled equity shares would be allocated to the central government, another portion (20%) allocated to local governments and the remaining 20% would be unbundled into enterprise specific shares and auctioned off to workers, managers and foreign investors associated with particular individual enterprises.[11] Permitting up to 20% of ownership concentration in specific enterprises to be acquired through preferential sales is believed to provide sufficient efficiency incentives for improved management. [12]

The proposed mass privatization program would distribute state assets by means of both sales and free give-away. Asset sales provide an immediate source of budget revenues during the critical transformation period when the fiscal system is likely to become dysfunctional. The sales also create initial asset markets in which tentative asset prices are established by the forces of supply

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9 In Russia, it may be impossible to determine the value of an enterprise whose assets include large receivables from other state enterprises. Given the magnitude of inter-enterprise arrears, and the uncertainties concerning the liquidation of particular enterprises, it becomes impossible to determine the likelihood that the receivables of any one enterprise are actually collectible.

10 When vouchers can be freely exchanged for cash the asymmetry of information creates the "carpetbagger" problem referred to by Feige(1990b) .

11 It should be noted that the creation of a broad class of citizen "shareholders" could take place rapidly since the bundling of shares precludes the necessity for valuation to precede distribution. The unbundled shares intended to be placed in the hands of the enterprise's future entrepreneurs will take time to distribute in a more evolutionary manner. As such, socialist privatization combines aspects of both Murrell's (1990) and Ericson's (1991) approaches with respect to the speed of the transformation.

12 Morck, Shleifer and Vishny (1988,1989) report that for Fortune 500 companies, "performance of firms with management ownership between 5 and 20 percent, as measured by profitability or by the ratio of market value to the replacement cost of assets, is indeed better than the performance of firms with management ownership between zero and five percent." However, they also find "that performance deteriorates as management ownership rises beyond 20%." NBER Reporter Fall 1989 p.9.

and demand. Preferential sale options available to managers, workers and foreign investors are designed to capture the efficiency advantages gained when entrepreneurial skills are matched with existing capital assets. The program permits sufficient concentrations of ownership in specific enterprises to provide incentives for asset preservation and enhancement. It simultaneously converts de facto property rights into de jure property rights.

The give-away component of the mass privatization program is motivated by both political and economic considerations. The widespread egalitarian distribution of property rights to citizens creates a constituency for further reforms. Its economic intent is to create an extensive pool of private savings that can eventually be channeled into investments in the emerging private sector. The government's share of bundled equities provides it with a long term source of revenues with minimal collection costs.

Privatization , Stabilization and Liberalization

In order to capture the positive synergism between privatization and stabilization, the revenues obtained from asset sales are sterilized in order to eliminate the monetary overhang. To further strengthen stabilization, state subsidies to consumers and firms are phased out, and hard budget constraints are imposed on the state sector. Military expenditures are cut back to regain fiscal balance. The reduction of fiscal deficits in turn reduces the need for further monetary expansion. Thus, the sterilization of the initial monetary overhang and the reduction of fiscal deficits reduce macroeconomic stock and flow imbalances, tempers inflationary expectations and acts as a brake on the price level. Once the economy is stabilized, price liberalization (decontrol) can be completed without the threat of initiating inflation.

The distribution of income yielding citizen shares creates a natural income and wealth safety net for the populace at large to help weather the short-term transitional costs of structural reallocation of resources.[13] The distribution of citizen shares also creates a broad base of private savings and a diversified consumer market. The bundling of enterprise equities and their wide distribution among citizens and government agencies serves to pool the risks and rewards of the transition process. Governments and citizens retain similar stakes in the success of the reform package. Rapid equitable mass privatization reinforces stabilization and liberalization and creates a broad political constituency for reform.

The liberalization reform frees the power of the market to allocate resources more efficiently.

[13] Given the magnitude of the required structural transition, unemployment is likely to rise significantly and most likely be of longer duration. Since income payments from citizen shares will be insufficient to compensate for lost labor income, additional targeted safety net policies are required. Theses include job retraining and unemployment compensation programs. The most effective means of reducing unemployment is to create incentives for the rapid development of the private sector. and improved labor mobility.

Since all citizens become residual holders of a substantial portion of pooled equity shares, they participate equally in both the gains and losses that result from resource reallocations and structural changes. Many state enterprises that were constructed and rationally managed under the central planning regime emerge as value subtracting enterprises when their outputs and inputs are evaluated at market prices that reflect true scarcity values. Given the irrationality of continuing to produce outputs that are worth less than the sum of their inputs, it is essential that non-viable value subtracting firms be rapidly closed. The closing of non-viable enterprises creates short-term hardships for their workers but it is socially preferable to provide these displaced workers with unemployment compensation and relocation aid than to continue to subsidize value-reducing production.

Many of the essential features of this type of reform strategy are now widely accepted by policy makers in formerly planned economies. It is generally recognized that ideally, all of the key components of the reform strategy should be introduced together so that each can benefit from the reinforcing effects of the others. This synergy provides the theoretical justification for the "big bang" approach to reform which calls for all elements of the reform package to be simultaneously put into effect. Unfortunately, these ideal circumstances cannot be realized in practice because each of the reform components (stabilization, privatization and liberalization) requires a different length of time to implement. Price liberalization requires the shortest period of time to implement while privatization requires the longest period.[14] The time period required for stabilization to effectively take hold may be quite long and highly variable. Under these circumstances it is best to immediately initiate privatization and stabilization and allow full liberalization to follow only after prices and budgets have been brought under control. Announcing all components of the reform strategy at once and then scrupulously maintaining the announced programmatic schedule so as to gain credibility for the reform process can minimize destabilizing expectation effects.

The emerging consensus on the essential requirements of a reform strategy has yet to be confirmed by empirical evidence accumulated in the wake of successful historical experiments with radical transitions to market economies. Actual reform experience suggests that the process of achieving a sustainable and stable transformation to a market economy may be lengthier and far more difficult than was initially supposed. In order to appreciate the complexities of the process, and to learn its lessons, it is useful to review the experience of the Soviet Union during the past few years as it vacillated between reform impetus and retrenchment.

Reform Cycles in the Soviet Union

[14] The experience of the United Kingdom and Eastern Europe suggests that the time required to complete enterprise by enterprise privatization sales must be measured in decades rather than in years.

Prior to its dissolution, the Soviet Union faced a constitutional crisis,[15] the threat of civil war and massive economic dislocation. To appreciate the gravity of the situation one must imagine the United States simultaneously confronting its three major domestic historical challenges: the constitutional crisis of the Federalist period, the bloody civil war fought to resolve the crisis over state rights and property rights, and the Great Depression.

The constitutional crisis in the former Soviet Union was manifest in the "war of laws" in which legislative bodies at all levels of government scrambled to assert the supremacy of their enacted legislation over that of the central government. At issue, were fundamental questions concerning ownership and control of property, land and mineral resources as well as republics' claims to fiscal revenues and their assertions of independent control over monetary affairs. The break up of the Soviet Union into independent republics broke the control of the "center" but left unresolved the problem of property rights between and within the republics. Complex issues of fiscal federalism and monetary union remained unsettled. Ethnic strife within and between republics occasionally flared into armed conflict and continues to threaten a wider civil war. Symptoms of the economic crisis included sharp reductions in output and labor productivity, inflation, huge budget deficits; sizable diversions of state resources into the underground economy,[16] and a flight from currency into costly barter transactions.

Step by Step Perestroika

With the initiation of perestroika in the mid 1980's Gorbachev signaled a willingness to undertake "step by step" economic reforms. These included the anti-alcohol campaign, the Law on State Enterprises and the Law on Cooperatives. Each of these partial reforms produced unintended consequences. The anti-alcohol campaign deprived the government of a major source of revenue, stimulated criminal bootlegging and caused a shortage of sugar. The centerpiece of the reforms was the Law on State Enterprises, which conveyed greater decision making authority to enterprise managers and abolished mandatory output targets. Central planners and ministries remained responsible for long term strategy and state procurement contracts continued to dominate enterprise production orders. The loosening of controls led to greater diversions of state property to the

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[15] The constitutional crisis was precipitated by what is now referred to as the "war of laws", the conflicting claims of various legislative bodies to the supremacy of their own enacted legislation. The most dramatic cases involved the confrontations between the Republican Supreme Soviets (the Baltic and the Russian Federation) and the Supreme Soviet of the USSR. Under Soviet law, the judicial powers of the Supreme Court were insufficient to adjudicate these disputes. To complicate matters, the Committee on Constitutional Supervision of the USSR which was itself appointed by the legislative branch of government (the Supreme Soviet of the USSR) had the powers to suspend presidential decrees believed to be unconstitutional and could suspend or call to the attention of the Supreme Soviet that fact that some of its own legislation was unconstitutional.

[16] Shatalin (1990) cites various estimates of the size of the underground economy suggesting that it approached 20% of GNP. (p.97-98)

underground economy and permitted enterprises to raise real wages in excess of productivity increases. The Law on Cooperatives created a fledgling "private" sector with greater flexibility to lease property, hire outside labor and attract capital. Yet by 1990, the cooperative sector accounted for less than 4% of the labor force and the economy continued to flounder.[17] Step by step liberalization loosened government control over budgets and monetary emissions and thereby created even greater macroeconomic imbalances. It was not until the summer of 1990, that it appeared that Soviet leaders were finally prepared to revitalize the moribund economy by abandoning central planning and initiating more radical policies to effect a painful but necessary transition to a market economy.

The Shatalin-Yavlinsky Reforms

The "500 Day Plan",[18] fashioned by the reform minded economists who then served as principle advisors to Gorbachev and Yeltsin,[19] formulated a comprehensive political and economic program for transitional reforms. It adopted the radical principle of distributing state property to the people (Feige, 1990a) by implementing a mass privatization program. The introduction to the 500-Day Plan was bold in style and libertarian in sentiment:

> "the state was wealthy while the people were poor,..the program sets forth the task of taking everything possible from the state and giving it over to the people...Everybody has a right to choose, guided by his own wishes and capabilities, whether to become an entrepreneur, an employees of the state apparatus or a manager at a stock company, to engage in individual labor, or to become a member of a co-op. The reform grants citizens the right to economic self determination, setting the rules which will prevent certain people, groups of people, enterprises and regions from infringing upon the economic rights of others while pursuing their own interests. It is freedom of choice which makes the basis for personal freedom of the people, for the realization of the creative potential of a personality." The right to property is realized through denationalization and privatization, giving over the state property to citizens. By giving property back to the people the social orientation of the economy will manifest itself. This is not a revenge act, but an act of social justice, a form to fix the right of man to his share in present and future national wealth. . The program gives equal chances to everybody. But this equality of opportunity should not be seen as a mirror reflection of egalitarianism."

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17 A full analysis of the economic events of this period can be found in (OECD, 1991) and Goldman (1991).

18 Shatalin (1990)

19 The main authors of the 500 Day Plan included Stanislav Shatalin (Member of the Presidential Council), Nikolai Petrakov (Personal Economic Advisor to the President), Grigory Yavlinsky (Deputy Prime Minister of the Russian Federation) and Boris Fedorov (Minister of Finance of the Russian Federation).

The political aspects of the program called for the devolution of central powers through the establishment of a "new Economic Union" comprised of "sovereign states united voluntarily" with a view to "stop disintegration of inter-republican links" in order to "create new incentives for economic integration based on the free will of all Republics and due regard for their interests".[20] The powers not explicitly ceded to the "center" were to be reserved for the Republics. The 500 Day Plan acknowledged the systemic failure of the central planning system and candidly recognized that the nation was facing:

> "a general crisis of the socio-economic system, including the national structure and ideology - a crisis that has exposed the non-viability of the existing structures."

The Transition to the Market report went on to analyze the alternative options available to Soviet policy makers. It foresaw that a continuation of the government's "half measures and gradual economic reforms" would bring on the "disintegration of the economic system" and the "final collapse of the Union". The report also warned that a realistic alternative was the reactionary scenario, a reversion to the old system of centralized planning. This option would necessitate "large scale political repression" which would return the nation to the "suicidal" course that "has driven the country to the curb of world progress". The option advocated by the authors of the 500 Day Plan included "the preparation and implementation of a radical economic reform aimed to create the foundations for a market economy." The empirical evidence of western experience that supported the superior efficiency of a market economy justified the radical reform option. The report argued that if the Soviet Union ignored the "universal nature of laws of economic and social development", it would do so at its own peril. The plan envisioned a rapid and radical transformation toward a market economy that included a overly optimistic timetable for implementing macroeconomic stabilization, privatization and liberalization.

Despite Gorbachev's initial endorsement of the 500 Day Plan, and its rapid adoption by the Supreme Soviet of the Russian Republic, Gorbachev replaced it with a diluted set of "Basic Guidelines"[21] which he submitted to the USSR Supreme Soviet for adoption. The "guidelines" eliminated many specifics of the original plan, including the timetable for implementing reforms but still asserted that:

> " The choice of transition to a market (economy) which has historic meaning for the fate of our country has

[20] ibid. p 10.

[21] "Basic Guidelines for the Stabilization of the National Economy and the Transition to a Market Economy" published in Izvestiya , October 18, 1990, pp. 1,3.

been made. The question now lies in how to implement the choice."[22]

Gorbachev's "Basic Guidelines" called for the "the improvement of finances and the money supply by reducing the state budget deficit and suppressing the issuance of money". The plan envisioned the maintenance of a single currency, controlled by an independent central banking authority modeled on the U.S. Federal Reserve System.

In the context of Soviet politics, the most controversial aspect of the 500 Day Plan was its explicit call for "the destatization and privatization of property, and the implementation of land reform."[23] Western economists hailed the advocacy of destatization and privatization as an explicit acknowledgement that a market economy could only be built on the basis of the institution of private property. However, more careful scrutiny of the political interpretations given to the terms "destatization" and "privatization",[24] revealed that they meant very different things to soviet leaders than to western economists. Destatization was broadly interpreted in the west to mean the conversion of state property to private ownership. In soviet circles it meant a continuation of the program of "self financing" of state enterprises that had begun with the new laws on state enterprise. The meaning of destatization was clarified in a presentation to the USSR Supreme Soviet on October 18th, 1990 by Academician Abel Aganbegyan,[25]

> "First, I would like to say that destatization is a fairly general process, the essence of which is the separation of the function of economic management from the function of state administration. This is a policy of granting independence to enterprises and economic bodies which are responsible themselves for their own revenue and their own expenses and, consequently, enjoy a wide range of rights of self-financing and many other rights."

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22 As reported in the Wall Street Journal, October 17th, 1990 p. A15. The "Basic Guidelines" represents a compromise between the "500 Day Plan" and the government's earlier program on Regulated Market Economy Structure and Mechanism Formation (identified with the former Council of Ministers Chairman N. I Ryzhkov). The Ryzhkov plan argued that "the Soviet Government considers the entire package of measures taken to transform the economic system as aimed at the introduction of a socially-oriented market economy", and speaks of the "destatization of property" - a full-scale process of transforming state property into other forms" [Program on Regulated Market Economy Structure and Mechanism Formation, September 1990 : Pages 2,8 and 9].

23 On October 9th, 1990 the CPSU Central Committee plenum published its reactions to the Supreme Soviet's adoption of Gorbachev's proposals concerning the transition to a market economy. The CPSU's support for the continuation of central planning is made clear by its statement:

> " The CPSU Central Committee insists on effective actions by governmental bodies to maintain economic ties, to observe contractual discipline" and, "While supporting diversity of form when withdrawing enterprises from state control, the CPSU Central Committee at the same time advocates priority for collective forms of ownership" and "does not support the idea of handing over or selling land to private ownership." [FBIS -Daily Report -SOV-90-199, October 15, 1990 p. 27-28]

24 [FBIS SOV-90-203, October 19, 1990. p. 33]

25 [FBIS SOV-90-203, October 19, 1990. p. 33]

Aganbegyan, regarded as one of the founders of Perestroika, revealed the depth of the ambivalence still felt toward private property when he publicly observed:

> "Privatization is not a good word. .. Privatization is not a switch to private property. It is a more general term, connected with a change in owner. ... We should not think that the authors of the program believe that private property should prevail in our country, and so on. This section states firmly that the right of private property is recognized, and that is all." (Emphasis added) [26]

As Gorbachev sensed opposition to reform mounting, he withdrew his support from the reformers and thereby encouraged the opponents of reform to initiate policies that destroyed whatever credibility the promise of reforms had sought to establish. The first such move was the clumsy recall of fifty and one hundred ruble denomination notes along with the imposition of strict limits on withdrawals from saving bank accounts. Under a presidential decree, the KGB was granted new powers to seize the accounts of cooperative (private) enterprises. The government went on to decree significant increases in the prices of goods and services, representing yet another attempt on the part of the central planners to "get the prices right" rather than to allow prices to be determined by market forces. The confiscatory nature of these policies served only to further devalue the fragile set of tentative property rights created by earlier reforms and to set back whatever credibility the government had gained as a champion of reform. The rejection of the economic aspects of the 500 Day Plan also led to the postponement of its critical political component, namely, the agreements that had been reached by the republics concerning the terms on which they would continue to support the Union.

The adoption of the Union Treaty was finally scheduled to take place on August 20th, 1991. On August 19th, conservative forces attempted to preempt its passage with a coup that failed. The attempted coup brought about the dissolution of the Soviet Union and abruptly swung the political pendulum back toward an agenda of more radical economic reform. Under the leadership of Russia's President Yeltsin, the newly formed Gaidar government moved rapidly toward implementing key elements of market reforms.

The Yeltsin-Gaidar Reforms

On January 2, 1992, Russia, the largest and most influential member of the newly created Commonwealth of Independent States (CIS), embarked on a closely observed economic experiment whose consequences are shaping the nation's political and economic future. The Russian leadership opted to mimic the Polish "shock therapy" model. Without the benefit of prior monetary and fiscal

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[26] [FBIS SOV-90-203, October 19, 1990. p. 33]

stabilization measures, the government committed itself to the administratively easy though politically costly measure of decontrolling most prices. Following the Polish model, they postponed stabilization, de-monopolization and privatization until after the price liberalization action. Yeltsin explained the flawed sequence of reforms as follows:

> "The most difficult and the most urgent measure was the deregulation of prices. No doubt it be preferable first to patch up the hole in the budget, and to cease endless emission, to stabilize money supply and to carry out the whole of privatization, as it should be done in a civilized way, and only then to set prices free. Yes, that is the textbook option. But, regrettably, we already have missed the opportunity for this option because the people's trust has reached its limit." January 11, 1992[27]

The first consequence of price liberalization was to bring the previously suppressed inflation into the open by permitting state prices to reflect the demand pressure exerted by the "ruble overhang".[28] In the past, shortages of consumer goods had been rationed by ques and by black market prices in the underground economy. Since the "ruble overhang" represented the stock of excess cash waiting to be spent, its release into the official markets caused a once and for all rise in the official price level. The initial price shock increased the average price level fourfold.

Second, and with more lasting consequence, the liberalization reform eliminated the planned economy's traditional macroeconomic policy instruments, namely price and wage controls. The macroeconomic task of the former planners had been to set the average wage rate and the average consumer price level so as to achieve an exact balance between the total wage fund and total consumption expenditures. When the wage fund exceeded total consumption expenditures, consumers found themselves with excess cash balances whose cumulated sum formed the "ruble overhang". Setting the average wage rate was analogous to collecting an income tax from workers. Fixing the average consumer price level was similar to the imposition of a sales tax. Relinquishing both wage and price controls effectively eliminated the government's ability to collect taxes. Having surrendered its traditional implicit tax base, the government levied an explicit value added tax. Inadequate administrative preparation along with high VAT tax rates made non-compliance commonplace, depriving the government of sorely needed tax revenues. Despite serious efforts to cut expenditures, the government found it impossible to restore fiscal balance.[29] The government, incapable of financing the deficit with either taxes or borrowing, was left to passively finance the

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27 FBIS-SOV-92009 January 14, 1992 p. 34.

28 For a full explanation of the "ruble overhang" and how it was originally generated see Feige(1990b;1991).

29 The 1991 budget deficit was roughly 20% of GDP.

deficit by running the printing presses. What emerged was a textbook receipt for accelerating inflation.

The price liberalization program, unconstrained by stringent fiscal and monetary stabilization unleashed further inflationary expectations and increased the fragility of the monetary system. The liberalization program did not induce the hoped for supply response in production. In fact, measured output fell off precipitously. The actual decline in production is difficult to assess because output measures may themselves be flawed, underestimating increased output in the emerging private sector and overstating output decreases in the public sector. Actual declines in output reflected decreased demand for military and export goods and production bottlenecks created by a disruption of traditional channels of supply. The breakup of the Soviet Union into independent republics initially gave each republic the ability to increase fiscal expenditures and thereby export inflationary pressures to all other republics. Efforts to control this practice, created export controls that significantly reduced inter-republican trade and thereby compromised channels of supply.

The partial nature of the price liberalization program also contributed to the reduction of output. Although most retail and wholesale prices were decontrolled, energy prices continued to be controlled at levels that were a fraction of world prices. Given the expectation that energy prices would eventually be raised to world levels, rational managers restrained oil output in anticipation of profiting from future price rises. The extraordinary degree of industrial concentration and the absence of domestic or foreign competition permitted large state enterprises to fully exploit their monopoly positions by raising prices and actually reducing output. With the collapse of state orders and the breakup of the Union, inter-enterprise trade suffered and distribution bottlenecks became more prevalent. Finally, in the absence of a developed capital market and an effective inter-enterprise payments mechanism, large scale state enterprises began to issue and accumulate debts to other enterprises. The buildup of inter-enterprise arrears resulted from the inadequacy of the payments system and from incentives and information distortions.[30] The potential financial failure of a major segment of state owned enterprises, and the concomitant threat of widespread unemployment has created great political pressure from the military and industrial enterprise interests on the central bank to issue vast new credits to offset the massive accumulation of inter-enterprise arrears.

The central bank, an institution beholden to the parliament, is yielding to enterprise interests by expanding non-cash credits to accommodate the inter-enterprise arrears with newly created credit. Inter-enterprise arrears increased from R40 billion to more than R3.2 trillion during 1992. By accommodating inter-enterprise debt, the central bank avoids the immediate consequences of enterprise failures but it effectively reinstates the "soft budget" constraints demanded by leaders of

[30] Summers (1992) contains an overview of the payments mechanism and (Ickes and Ryterman, 1992) explain how the institutional arrangements concerning payments and credit allocation provided incentives for enterprises to make loans at negative real interest rates to other enterprises whose solvency was itself virtually impossible to determine.

the enterprises. The central bank justifies the accommodation of inter-enterprise debt as being necessary to provide working capital to enterprises. Without this working capital, the enterprise sector could implode leading to massive unemployment and a radical collapse of output. As Ickes and Ryterman (1992) point out, the growth of inter-enterprise arrears has made it increasingly difficult to distinguish viable from non-viable enterprises. As such, imposing hard budget constraints, might force the shutdown of enterprises that are illiquid but solvent. To accommodate inter-enterprise arrears destroys whatever credibility the reform program had established in attempting to force state enterprises to respond to market rather than central planning incentives. The accommodation of arrears will lead to another round of money supply creation and bring the economy closer to a hyperinflation that could bring about the collapse of the entire monetary system.

The rapidly accelerating inflation has resulted in part from the monetary expansion arising from the maintenance of a ruble zone without adequate monetary controls. Each republic in the ruble zone has the incentive to capture short-term concentrated gains from public expenditure. The inflationary consequences of the monetization of these budgetary deficits are widely diffused over all the other republics.

Fiscal deficits continue to be financed by the creation of cash and non-cash components of the money supply. This monetary expansion, and not the reforms themselves, has created a monetary system exhibiting symptoms of acute dysfunction. The ruble is not viewed as a viable store of value and is rapidly being displaced as a medium of exchange by goods and foreign currencies. The real rate of interest on monetary instruments is negative and there is a growing concern over the moral hazard in the newly emerging system of "private" commercial banks. The high inflation rate swamps the relative price information conveyed by the emerging price system and thereby robs it of its allocation function. The monetary instability reduces the likelihood that the ruble can attain the status of a convertible currency and thereby denies the economy the benefits of international trade and competition. Finally, the macroeconomic instability calls into question the ability and desirability of maintaining a common currency zone for the CIS. In short, unless monetary stability and a functioning monetary system are rapidly reestablished, the entire reform movement may be dealt a setback from which it is unlikely to recover.

The inappropriate sequencing of reforms diminished the salutary effects that price liberalization had hoped to achieve. Without the benefit of prior stabilization and privatization, relative price changes were overwhelmed by the inflationary erosion of domestic purchasing power. In the absence of domestic and foreign competition, limited entry and exit into existing markets, and the extraordinary degree of industrial concentration and monopolization, freed prices did not reflect true scarcity values. With inflation rampant, it became impossible to create the preconditions for establishing the ruble as a convertible currency. [31] The inability of the government to impose adequate fiscal and monetary restraint has also cost the government the long sought for aid of international organizations. The International Monetary Fund had scheduled aid on the order of $24 billion, but to date, only a small fraction of the promised aid has been forthcoming. The original plan to create a stabilization fund to make the ruble an internationally convertible currency has been rendered inoperative by the failure to stabilize the currency domestically. As hyper-inflation becomes more likely, the continued erosion of the ruble's value both domestically and internationally appears inevitable. Despite government denials, a radical currency reform similar to that undertaken during the New Economic Policy of the early 1920's may be the only solution for reestablishing stability once hyperinflation has taken hold.

The postponement of privatization deprived most citizens of rights to real property that could have served as an asset shield from the inflation tax. The major impact of the inflation has been a massive redistribution of income from holders of monetary assets to holders of goods and real assets. Since the holdings of durable goods and assets were highly skewed toward the old nomenklatura, the major consequence of the inflation tax has been to redistribute existing wealth in a highly regressive manner. The inflationary asset redistribution has wiped out the monetary savings of many citizens. Faced with lower real wages and growing prospects of unemployment, popular support for the reforms is eroding. Another cycle of reforms appears to be coming to an end as pressures mount for a drastic slowing of the reform process.

Evaluation

When viewed from the perspective of seventy years of authoritarian centralized control over all facets of political and economic activity, the scope and speed of the recent reforms initiated in the Soviet Union is nothing less than extraordinary. Within a short span of years, political leaders have adopted, and large segments of the public have accepted, an entirely new agenda for their economic and political future. The fundamental decision to abandon central planning and replace it with market mechanisms for organizing economic activity has been made and will be difficult to reverse. A variety of transitional reforms have been attempted with varying degrees of success.

Domestic liberalization in the form of price decontrols and decentralization of decision making has been widespread. A critical exception is the maintenance of controls over energy prices which are still maintained at a fraction of world prices. The freeing of prices has reduced ques and has increased the variety of goods available in a limited sector of the market. But in the absence of successful stabilization and privatization, liberalization has not achieved the goal of increasing the

[31] Feige (1991) and McKinnon (1991) describe preconditions for external convertibility and its relationship to domestic reforms.

supply of output. The failure to stabilize the economy merits particular attention because hyper-inflation now presents the single greatest threat to the continuation of the reform process.

The failure to achieve macroeconomic stabilization during the process of transitional reform resulted from a variety of inter-connected causes. Most important among these was the inheritance of a monetary overhang, a repressed inflation and a large budget deficit from the era of central planning. The monetary overhang and the repressed inflation could have been eliminated by a privatization program that exchanged state property for excess rubles. Unfortunately, the needed privatization program required a lengthy time period to initiate and its introduction during the early phases of perestroika was politically untenable given the widespread ideological resistance to any notion of "private property". The inability to sterilize the ruble overhang assured that a once and for all rise in the price level would accompany any price decontrol liberalization program. This initial burst of inflation set off further destabilizing expectations and created strong political demands for fiscal expenditures to compensate workers for lost purchasing power. The distributive burden of the inflation fell on the shoulders of money holders, namely the vast majority of Soviet citizens whose only legal form of savings were ruble hoards and savings accounts at state banks.

Continued inflation resulted from the government's inability to bring the fiscal budget under control. In the absence of a market for government bonds, all government expenditures had to be financed by taxes or through money creation. Once price and wage controls were relaxed, the government lost its conventional tax base and was forced to rely on new and unfamiliar taxes which became increasingly difficult to collect. Under these circumstances, fiscal stringency required slashing government expenditures. The reduction of consumer subsidies and military expenditures had to be supplemented by the imposition of credible hard budget constraints on large scale state enterprises. In short, any government that hoped to provide the appropriate microeconomic incentives for enterprises to adjust to market conditions had to establish a stable macroeconomic environment in which market information signals were explicit and uncontaminated and a property rights system that gave property owners the opportunity to profit by following market incentives.

In the face of an initial tightening of financial subsidies to state enterprises, the enterprises themselves created a pyramid of inter-enterprise debts which they hoped would be repaid by yet another relaxation of hard budget principles. At the critical juncture where fiscal credibility might have been established at the cost of some major enterprise failures, the central bank circumvented the government's attempts at restrictive policy by bailing out the credit hungry enterprises with more state subsidies. The benefits of this action were highly concentrated in the military industrial complex whereas the costs were diffused over the entire population through another round of inflation taxation.

Another difficulty in the stabilization effort resulted from the maintenance of a common ruble zone in various republics without an institutional centralization of monetary authority. Each member of the ruble zone maintained the ability to inflate at the expense of all the other members of the ruble zone. Once again, the direct benefits of inflationary expenditures where concentrated in each republic whereas the inflationary costs were diffused over all republics. This failure of inter-republican financial arrangements will most likely force the abandonment of a single monetary unit. Separate republican currencies will shrink the present ruble zone. Even Russia will be forced to replace the current ruble through a fundamental monetary reform unless some means can be found to forestall the threatened hyper-inflation.

Recent applications of game theory to transition problems (Fernadez and Rodrik, 1991) and (Alesina and Drazen, 1991)] reveal the interdependence between distribution issues and stabilization reforms. Stabilization reforms are often delayed, and efficiency enhancing policies often fail to be adopted because of both the uncertainty concerning the distribution consequences of the reform policies and by wars of attrition between groups hoping to acquire a disproportionate share of the gains. If stabilization reforms are to succeed, their distribution consequences must be more transparent and must benefit a broad political constituency. What is required is that the implicit redistribution of wealth that is now accomplished by inflation, be replaced by an explicit program of wealth redistribution through privatization - the creation and distribution of valued property rights.

Privatization programs, like stabilization programs will be delayed so long as their distribution implications are poorly understood. What is needed is a transparent mass privatization program that can be rapidly implemented. The program must contribute to fiscal stability by providing the government with a source of revenue that is collectable at low cost. It must provide efficiency incentives to produce new wealth rather than to simply redistribute existing wealth, and it must credibly demonstrate that the conversion of state property into private property conforms with distribution norms of equity. Conventional privatization, that is, the enterprise by enterprise sale of state assets requires too much knowledge and too much time to be an effective means of creating a functioning market economy. Socialist privatization, on the other hand, combines the rapidity and equity of privatization from above (the free distribution of a sizable portion of the pooled residual claims to large scale state property to the entire population) with the evolutionary and efficiency orientation of privatization from below (the sale of small scale state property to private owners at the local level and the auction of the unbundled portion of large scale enterprise shares). Employing both methods assures that the transfer of state property into private hands need not be postponed until the valuation of that property becomes feasible. Valuation of the large scale properties must await the resolution of the inter-industry debt crisis and the establishment of credible hard budget constraints.

The cyclical pattern of observed reforms suggests that political time horizons are considerably shorter than the time horizons required to create and maintain a credible reform program. A necessary if not sufficient condition for lengthening the political lifetime of reform minded policy makers is to create a broad political constituency for reform. One important constituency for market reforms will be the emerging private sector of the economy. To facilitate the growth of this private sector, mass privatization is essential and it must be accomplished rapidly.

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