

Perestroika and Socialist Privatization: What Is To Be Done? And How?

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I must confine myself to expressing my conviction, which is based on my observations of what is going on. During the past year we showed quite clearly that we cannot run the economy. That is the fundamental lesson. Either we prove the opposite in the coming year, or Soviet power will not be able to exist. And the greatest danger is that not everybody realizes this.

*Lenin, Communism and the
New Economic Policy, 1922*

Introduction

The convulsive changes initiated by perestroika have brought communist nations to a historic crossroad. The

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Soviet Union is redefining and restructuring communism even as Eastern Europe flees it. But the paths these nations ultimately choose need not lead them to capitalism as we know it in the West. The conceptual challenge they face is to structure a new order, one that absorbs the most beneficial economic institutions of capitalism into a socialist value system. The means of achieving these goals are as elusive today as they were to the architect of the Soviet revolution.² The purpose of this paper is to describe the destination envisioned by perestroika and to sketch one possible itinerary for getting there. The transition route is strewn with major obstacles including inflation, unemployment, bureaucratic obstruction and demands for regional autonomy. These impediments must be circumvented by a sequence of reforms that assure sustained progress toward the final goal. The path I propose is a program of "socialist privatization" – an egalitarian redistribution of the state's custodial assets to its citizens as a prelude to a "contained big bang" introduction of market mechanisms.³

General Principles

Mikhail Gorbachev's call for a "humane democratic socialism" encompasses both commentary and hope. It is at once a critique of the systemic failure of the Soviet experiment and a vision which articulates the unfulfilled ideals of socialism. Gorbachev's perestroika aspires to create a cooperative society characterized by social justice,

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2. "By what stages, by means of what practical measures humanity will proceed to this supreme aim we do not know and cannot know." Lenin (1918) quoted in Tucker (1975, p. 382).
 3. The essentials of the "socialist privatization program" appear in Feige (1990a, 1990c).

security, prosperity, equality and democracy.⁴ Social justice implies the toleration of diversity under the rule of law, impartially administered. Security demands protection from external and internal threats to life, liberty and property. Prosperity requires innovation, productivity and efficiency in production and distribution. Equality calls for universally distributed rights and resources.

The hallmarks of true democracy are equality of opportunity and the freedom to choose among alternatives. The political freedoms of speech, expression and travel have been extended by glasnost. But genuine democracy requires the grant and guarantee of a *dual franchise*, the right to vote with ballots *and* the right to vote with economic resources. Both rights are meaningless in the absence of alternatives from which to choose.⁵

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4. These goals have been reaffirmed in the Abalkin Committee Report to the All-Union Conference: "The ultimate goal of a radical economic reform is sound economics able to ensure a highly efficient production, to reach the living standard compatible with modern living standards, to ensure social justice and a possibility to solve the most urgent ecological problems. Only then can we speak about the completion of perestroika and the success of the reform. Only then will the prerequisites for the development of the Soviet society be created in conditions of freedom and democracy. Only then will the ideals and standards of socialism be established." *Radical Economic Reform: Top-Priority and Long-Term Measures*, All-Union Conference and Workshop on Problems of Radical Economic Reform, November, 1989, p. 4.
 5. The critical relationship between economic freedom and democracy was recently acknowledged by A. N. Yakolev, a member of the CPSU Central Committee Politburo and secretary of the CPSU Central Committee, who wrote: "Economic freedom is the foundation of democracy. The USSR Supreme Soviet is preparing to consider the Law on Freedom of Entrepreneurship, freedom of economic operations. However, this is but a segment of economic freedom which incorporates a right to property, a right to land, a right to payment according to labor, a right to freely control one's

Effective political freedom necessitates the availability of political alternatives. These can only be assured by constitutional guarantees that establish political plurality as evidenced by a multi-party system representing a diversity of political choices. Effective economic freedom requires the availability of economic choices reflecting individual preferences. These are best provided by multiple markets, whose price signals convey diverse consumer preferences to competitive producers and who are in turn free to respond by providing a wide range of economic alternatives.

Equality of opportunity requires that the dual franchise be universal. "One person, one vote" is a simple rule for establishing equality of opportunity in the exercise of political freedom. No such easy formula obtains to assure equality of opportunity in the exercise of economic freedoms. The problem arises because every exercise of economic freedom affects the distribution of economic resources, and any attempt to impose equality of outcomes necessarily compromises economic freedom (Friedman and Friedman 1980, pp. 134-35). Although it is impossible to assure equality of outcomes, it is possible to create a level playing field by establishing full rights to private ownership and an egalitarian distribution of economic resources with which citizens can cast their economic votes.

The Challenge

From the Soviet perspective, the communist experiment has achieved a reasonable degree of security and equality, but at a great cost to democracy and

labor and intellect, and so on." Kishinev - *Sovetskaia Moldaviia*, April 27, 1990, pp. 1-2.

efficiency.⁶ Soviet leaders view western capitalism as suffering from the reverse problem, having achieved democracy and efficiency at great cost to equality and economic security. Perestroika must find the means to adopt those particular institutions that have brought democracy and efficient economic organization to western nations, without subjecting socialist society to the inequities and instabilities that it perceives to be inherent in capitalism. The intellectual challenge is to conceive a novel form of economic and political organization that eliminates the apparent contradictions between capitalism and socialism in order to capture the most salient advantages of each. How, then, can a communist nation, characterized by state ownership of the means of production and a centrally planned command system of allocation, reconcile socialism with capitalism?

A Possible Solution

The central thesis of this paper is that the highest principles of socialism can be attained by undertaking a program of "socialist privatization" in order to lay the foundation for the subsequent adoption of market oriented institutions and reforms. The nature, scope, sequencing and timing of reforms will determine the stability of the transition process.

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6. In fact, the Soviet system has established equality of poverty for roughly 85 percent of its population, who earn less than 200 rubles per month and whose consumption opportunities are constrained by the shortage of consumer goods and services. Roughly 10 percent of the population can afford to live at "middle class" standards while the remaining 5 percent constitute an economic elite. Since official earnings are maintained in a relatively narrow range, the two prime interrelated sources of inequality are the "privilege system" of goods distribution and illegal earnings in the underground economy (A. Kuteinikov 1990).

Socialist privatization begins with the constitutional grant and guarantee to all citizens of private property rights to real and financial assets. Its second stage calls upon the state to relinquish its stewardship of the means of production, and redistribute the nation's wealth (equity shares in state enterprises, agricultural land and the housing stock) to its citizens. The division of national assets anticipates portions for the central, regional and local governments, for workers, managers and foreign investors. The largest portion is reserved for Soviet citizens. The mechanism for redistributing state assets is a massive open market operation designed to achieve macroeconomic balance. The sale of assets to the public, in equal shares to each citizen, serves to absorb the present ruble overhang that threatens any reform with severe inflation. The sterilization of receipts from the open market sale restores monetary balance. The public's newly acquired earning assets form a wealth based safety net to cushion the economic dislocations that are bound to accompany any radical transformation of economic institutions. Providing each citizen a source of income from diversified capital and labor serves to pool risks and creates incentives for cooperative rather than competitive rent seeking or rent preserving behaviors.

Once monetary balance is restored by the sterilization of excess rubles, risks pooled, and citizens provided with income earning assets to buffer subsequent adjustments, additional institutional reforms are required to set the stage for the introduction of market oriented reforms. The most important of these is the breakup of the large state enterprises whose degree of concentration precludes competitive behavior.⁷ Relative prices must then

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7. Monopoly power is rampant in the highly concentrated industrial structure of the USSR. The combination of shortages, lack of competition, and soft budget constraints increase the power of concentrated enterprises to charge monopoly prices through the restriction of output. An essential feature of reform must be the breakup of these monopoly elements, creating in their place

be set free to seek their market clearing levels. In one "contained big bang" the price mechanism is liberated to perform its information and incentive signaling role. The "diktat" system of centrally planned administration must now step aside to permit the price mechanism to perform its resource allocation function. The explosive forces of the big bang are contained by a stable macroeconomic environment, the introduction of competitive elements and the shock absorber safety net put in place prior to the release of prices. This particular sequence of reforms is believed to be the one most likely to assure a sustainable stable transition path to Gorbachev's vision of a "humane, democratic socialism."

Socialist privatization establishes a secure and level playing field *before* unleashing the competitive forces of a free market. This is accomplished by first attaining monetary balance through the creation and equitable distribution of property rights through the open market sale of state assets. In contrast to the "shock therapy" Polish reform, which plunged the economy directly into the game of free enterprise with the deck stacked against workers,⁸ socialist privatization awards players an equal

economically viable smaller firms, subject to a standardized code of financial accounting and reporting. Institutions must be established to encourage the entry of small and medium sized firms to compete with existing enterprises and to provide specialized goods and services that are now inefficiently produced by huge firms characterized by both vertical and horizontal integration. Legal institutions must be restructured to enforce contracts and permit bankruptcy. Financial institutions must be established to assure hard budget constraints and to ease the entry of newly established competitive firms.

8. The Polish reform represents a particularly inequitable and destabilizing form of introducing "free markets." Without prior efforts to restore macroeconomic balance, product prices were freed to seek their market clearing levels, yet labor markets were constrained by wage controls.

number of chips before opening the free market casino. With the right to private ownership of resources legally established, resources would be equitably distributed. Only then would relative prices of factors and products be freed to clear markets and eliminate shortages. Market prices, uncontaminated by overall inflation, would now reflect both the availability of resources and the evenly weighted preferences of citizens exercising their economic franchise by voting in the market place. In short, an initial egalitarian redistribution of state custodial property establishes the socialist prerequisite of equality of opportunity. The subsequent adoption of free markets provides the information and incentive mechanisms that promote the much sought after gains from improved productivity and efficiency.

This radical form of perestroika represents a second Soviet revolution. It moves well beyond the critiques of the systemic failures of central planning to an articulation of a positive program capable of capturing public imagination and involvement. It promises to the people, the return of property long held in custody for them by the state, as the foundation for a more efficient and productive economy.⁹ Socialist privatization, by extending the economic franchise

9. The most recent proposal for reforms (*New York Times*, May 25, 1990, p. A8) suggests a limited plan for a gradual transition to a "regulated market economy." The proposal calls for a major rise in key consumer prices, effectively substituting consumption subsidies for production subsidies. Inexplicably, a national referendum is to be held (*New York Times*, May 24, 1990, p. A1) to approve a reform package which is perceived as promising little more than a massive increase in basic consumer prices. Predictably, the announcement has led to panic buying. If the leadership seriously seeks public support for a reform program, it is surely more likely to receive support for a referendum that calls for a distribution of state assets to each citizen, rather than one that asks approval of a planned doubling or tripling of the prices of basic necessities with a promise of partial compensation.

to all citizens, provides incentives for their participation in transforming the "revolution from above" to a revolution from below. It goes a long way toward resolving the ideological contradictions that have stifled past efforts to introduce the most useful elements of capitalist market mechanisms into socialist countries. It achieves this resolution by establishing private property rights over equitably distributed property as a preamble to market reforms. This sequence institutionalizes economic democracy by first distributing economic resources equitably and then giving free expression to economic choice through unfettered markets.

The idea of redistributing state property as the antecedent to the introduction of market reforms has direct applications for Eastern Europe as well. It would dampen inflationary pressure, reduce economic hardship, and limit the conversion of past privilege into present property. The announcement of a program of socialist privatization would stop the hemorrhage of human and physical capital that now threatens to drain these nations of their remaining economic vitality.

For example, socialist privatization would ease German economic reunification by creating a powerful incentive for stemming the flow of resources from east to west. An open market sale of state assets to the *resident* citizens of East Germany would privatize the economy in an equitable manner, giving each resident a real asset endowment to help endure the economic hardships of the transition period.¹⁰ It also provides a mechanism for

10. The most pressing problem facing East Germany is the emigration of more than 450,000 citizens during the past year. This mass migration has deprived East Germany of the young skilled workers needed for economic reconstruction and the maintenance of existing social services including health, transportation and administrative services. Since wage differentials and living standards between the FRG and GDR will continue to create incentives for further migration to the west, a socialist privatization program would provide a powerful incentive for GDR citizens to

converting East German marks into real assets. These custodial assets, held by the state for the people, effectively provide the backing for the state's outstanding financial liabilities. A swap of assets for East German marks eliminates the obsolete currency from circulation. It thereby circumvents the vexing problem of determining an appropriate rate of exchange between east and west marks.¹¹ The newly distributed assets for GDR residents would be priced by the market in terms of single unified currency. This smooths the unification transition and significantly reduces the burden of subsidies that would otherwise be borne by the welfare system of West Germany.

Ends and Means

For the sake of clarity, it is essential to distinguish between socialism as ideology articulating the goals toward which society strives, and socialism as instrumental politics describing pragmatic means to achieve political ends. The leaders of the Soviet Union increasingly acknowledge that the particular means adopted in the aftermath of the Soviet revolution have proved themselves incapable of

maintain their residency in order to retain their rights to the proposed distribution of state assets.

11. On May 18, 1990, East and West Germany concluded a treaty (expected to be ratified by July 2, 1990) specifying a three tier system of exchange rates. East German marks would be converted to the West German currency at exchange rates of 1:1, 2:1, and 3:1 with strict limits set for the amounts to be converted at the more favorable rates. Under the plan for German economic and monetary union, the West German mark is to become the sole medium of exchange in both nations. The issues concerning property rights and the privatization of East German state enterprises have been deferred for later negotiations.

promoting desired ends. Neither exclusive state ownership of the means of production, nor central planning, are requisite foundations for the attainment of socialist ideals. Both institutions are accidents of history, being neither necessary nor sufficient for the realization of socialist values. Indeed, it is their perpetuation that jeopardizes the very values that socialist ideology espouses. These institutions foster an authoritarian-bureaucratic system that is antithetical to egalitarian democracy. They establish the rule of privilege over the rule of law. Being incapable of efficiently managing a complex economy, they are counterproductive to the task of achieving prosperity.

Yet paradoxically, it is the very existence of state ownership and central control that presents communist nations with a unique historic opportunity. They alone can undertake an unprecedented redistribution of economic resources that does not require the expropriation of property. The ability to redistribute wealth without dispossession arises from the state's paternalistic role as custodial agent for the property of all its citizens. By abdicating this function, the language actually demonstrates the success of its stewardship, because in so doing, it achieves its long proclaimed goal of establishing an egalitarian distribution of property. It needs only return the property held for the people to the people. Every worker receives a private property right to a portion of existing capital. Ironically, the most direct way to eliminate the class struggle and achieve the egalitarian socialist ideal is to create a nation of equally endowed laborer-capitalists. The central planning apparatus has the administrative structure to effectively accomplish this massive redistribution before relinquishing its allocation functions to market mechanisms.

Redistribution – An Overview

The outright redistribution of the nation's wealth to its citizens, as distinct from either the decentralization of property envisioned by the proposed Soviet laws on ownership¹² or the insidious East European sales of state

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12. The ambiguous draft law on ownership appears to limit "private property" to an individual's personal possessions which include "their own labor force, monetary means, objects of individual and family consumption." Individual ownership "may include: valuable papers, means of individual, auxiliary and family household maintenance . . . property of a working household of citizens are those necessary for the independent management of the household." All other forms of ownership are either collective, or state property. The proposed law has been largely misunderstood in the west to broadly establish private property rights. Article 13 refers to "Associated property of citizens of the USSR . . . Citizens of the USSR as subjects of ownership have the right to create and participate in various forms of associated (public) property and ownership; collective ownership, of national-territorial and administrative territorial communities of people, the republics and the USSR" (*Ownership in the USSR*, November 1989). The draft laws pertaining to land also severely circumscribe private ownership rights. Article 20 grants "the citizens of the USSR the right to receive lots of land for ownership: for management of a peasant's household; for management of an individual subsidiary economy; for construction and servicing of a residential house; for gardening, vegetable gardening and raising livestock; for individual country-cottage construction; in case of purchase of a residential house in the country-side or inheritance of such a house by inhabitants of towns and working settlements. The legislation of the Union and autonomous republics may prescribe the granting of lots of land for ownership or for other purposes" (*About the Land*, November 1989).

property to a select few,¹³ conforms to socialist ideals. It establishes the fundamental institution of private property rights¹⁴ as the democratic basis for the effective functioning of market mechanisms.¹⁵ An equitable

13. The privatization schemes adopted by Eastern European countries permit the sale of state enterprises to private firms and individuals. They are often hailed in the West as bulwarks of free enterprise and entrepreneurship. In fact, they amount to little more than inefficient giveaway programs to the entrenched bureaucracy. The Hungarian "Transformation Law" (June 1989) and similar laws in Poland facilitate the transfer of public property to the private control of the nomenklatura, at prices well below true market values. These privatization schemes are not subject to public scrutiny and review. They provide meager compensation to the State, and essentially create a mechanism which permits the nomenklatura to capitalize their "rights of privilege" in the form of "private property." To date, there has been surprisingly little criticism of these lucrative closed sales of the *public's* custodial assets to the nation's nomenklatura or to foreign investors. This is all the more astonishing in light of the public concern expressed in the U.S. over the sale of *private* assets to foreigners. An exception is a recently reported scandal which forced the Hungarian government to suspend its privatization program in March, but it has since been resumed (*New York Times*, May 22, 1990, p. D5).
14. Private property guarantees the titled owner the rights to retain, invest, sell, distribute, disperse, transfer, and mortgage his property. It also entitles the owner to any income that derives from the property. Voluntary contracts enabling exchange between rightful owners of property are sanctioned and enforced by law.
15. The Abalkin Reform proposals recognize the fundamental importance of property rights, and make allusions to the "denationalization of property." According to the report: "One can venture to outline the principal features of the model of a new economic system within the framework of socialist options. First – diversity of forms of social property, their equality in rights and competition as the basic platform and guarantee of economic freedom of citizens, ensuring their possibility to make best use of

distribution of property gives substance to the exercise of property rights. Its aim is to establish a share economy in which citizens, in their dual roles as workers and capitalists, have an equal and direct stake in the outcome of the reform process.

Operationally, socialist privatization entails a distribution of titles to state assets among the central, regional and local governments, managers, laborers and foreign investors, with the largest percentage being equitably distributed directly to the nation's citizens. State enterprises and collectives are to be reconstituted as corporations, with newly issued equity shares representing titled rights to ownership as well as claims to income. A portion of these enterprise-specific shares would be earmarked for purchase by the workers, managers and foreign investors responsible for the operation of specific corporations. They would be given the right of first refusal to acquire shares in their enterprise at prices determined by public auctions. The remaining corporate shares would be bundled into "citizen shares" which are distributed to the general public, the central government, and to regional and local governments.

Socialist privatization achieves several microeconomic and macroeconomic objectives simultaneously. The unbundled enterprise-specific shares that are earmarked for workers, managers of the particular enterprise as well as for foreign investors, are intended to provide direct incentives for efficient management. This distribution

their own faculties and creating powerful individual and collective economic motivations. The diversity of forms of social property is in no way a transitional, but normal state of the economy. It opens the possibility of doing away with alienation of the working people from the means of production, from power and participation in managing economic affairs" (*Radical Economic Reform*, p. 2). A summary of these reforms is found in Hewett (1989).

establishes both self management and direct ownership.¹⁶ These shares would be priced at public auction, thereby creating a mechanism for individual equity valuation.

The public share distribution creates the occasion for building an institutional infrastructure to support and promote a market economy. Shares must be registered and legal titles to property must be conveyed to each citizen. With titles to property established and protected by new legal statutes, each citizen receives an income earning asset that provides insurance and security against transitional dislocations. Risks of specific corporate failures are now pooled and dispersed over the entire population. The procedure for distributing citizen shares to the public is also designed to establish a rudimentary banking system with deposit and lending facilities. The open market sale of citizen shares, at nominal prices, absorbs the state's excess outstanding financial liabilities which, when sterilized, eliminates the threat of an increase in the general price level.

The central government share allocation creates a revenue source for the financing of public expenditures, one that does not require direct taxation. The government simply collects dividend payments on its citizen shares in lieu of taxes. The shares appear as assets on the

16. Self-management alone creates a "rent-seeking" incentive for workers and managers to appropriate the rents of capital in the form of higher wages, salaries and bonuses. The failures of the Yugoslavian experiment attest to the dangers of providing workers and managers with incentives to maximize short term returns in the form of wage payments and bonuses at the expense of reinvestment of profits. The granting of direct ownership rights establishes the ability of workers and managers to accumulate, sell and transfer equity shares. Direct ownership therefore eliminates the incentive to decapitalize the enterprise. It creates positive investment incentives since owners of shares now have an incentive to maximize the value of the equity holdings which represent the discounted value of expected future income.

government balance sheet, and the government can issue its own liabilities against its assets. These fully backed government liabilities can be sold to banks and the public, enabling the central bank to exercise monetary stabilization policies through conventional open market operations. The full backing requirement places limits on monetary expansion.

Asset distributions to regional and local governments play a similar role, creating an autonomous revenue base for local authorities to determine a politically acceptable pattern of decentralized public expenditures. Furnishing regional and local governments with a portfolio of nationally based assets decentralizes economic and political power. It accommodates the growing demands for regional autonomy while creating incentives for interregional cooperation.

Finally, the distribution of shares to the various levels of government creates a unique structure of parallel economic incentives for public agents and private citizens. Government actions are motivated and monitored by both the political process and by the common economic incentives that government now shares with its citizens. The state and the public share comparable stakes in the outcome of reforms and therefore have compatible inducements to assure their success.

Once constitutional guarantees of private property rights are granted and state resources are equitably distributed, more efficient allocation and management of resources can take effect. There is a growing consensus among Eastern European economists and more radical Soviet reformers that free market mechanisms must replace central planning as a means for allocating scarce resources. To effect such a change, subsidies, price controls, soft budget constraints, production quotas, monopoly power, strict labor tenure and non-convertible currency must be abolished. The "diktat" system of centralized production controls must yield to market mechanisms, characterized by free entry and exit of firms,

labor and capital mobility, and allocation by market determined relative prices that reflect scarcity value and opportunity costs.¹⁷ Progress toward the adoption of efficient economic mechanisms of allocation is now blocked by the fear of inflation and economic insecurity.

The Transition Dilemma

To succeed, economic reforms must overcome several critical microeconomic and macroeconomic obstacles that menace the fragile transition. The Soviet Union currently lacks the legal and financial infrastructure required to support a market economy. The existing administrative and legal structure obstructs rather than facilitates commercial exchange. There is as yet no effective mechanism to promote financial intermediation between private saving and investment. Current industrial concentration is so great as to prohibit the establishment of meaningful competitive entry, and the continuation of soft budget constraints and subsidies prevent the exits, through bankruptcy, of unprofitable firms. Production inefficiencies are aggravated by a crumbling and overburdened distribution infrastructure, desperately in need of rebuilding. All of these microeconomic difficulties require immediate attention, but will not yield ready solutions in the short run.

The major macroeconomic impediments to successful reform include: 1) the stock problem of a "ruble overhang" that threatens any price decontrol program with a massive initial increase in the general price level; 2) the flow problem of a budget deficit, whose financing through money creation implies continued inflation; 3) the transitional unemployment created by the reallocation of labor and capital resources.

17. Excellent discussions of the strengths and weaknesses of the central planning system are found in Hewett (1988) and Ericson (1989a).

The Ruble Overhang

The most politically charged impediment to the rapid implementation of economic reform is the fear of inflation. This fear is well founded. History attests to the seriousness of the political upheavals that follow in the wake of reforms which produce inflation and significant declines in real income. This experience is particularly worrisome to Soviet leaders who anticipate that a relaxation of central controls will unleash a massive increase in the general price level resulting from the ruble overhang, and a continuous inflation resulting from budgetary deficits.

The ruble overhang is the cumulative result of past failures of central planners to create a monetary balance between the aggregate demand for consumer goods and the aggregate supply.¹⁸ An important source of this chronic

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18. The problem can be illustrated by a simple example offered by Paul Gregory and Robert Stuart in *Soviet Economic Structure and Performance* (1981, p. 145). The output plan calls for the production of Q_1 units of consumer goods and Q_2 units of military and investment goods. L_1 man-years of labor are required to produce Q_1 and, simultaneously, L_2 man-years of labor are required to produce Q_2 . If workers are paid wage rates W_1 and W_2 respectively, then the annual gross wage income paid in rubles is $W_1L_1 + W_2L_2$. The total monetary demand for consumer goods and services (D) is then:

$$1) D = W_1L_1 + W_2L_2 - T - R$$

where T denotes personal taxes and R denotes personal savings. Given the existing consumer price level (P_1), the total supply of consumer goods at established prices (S) is the total value of consumer goods (P_1Q_1) so that:

$$2) S = P_1Q_1$$

If the consumer price level (P_1) is fixed and personal taxes are given, then in each year, "forced" savings (R) = $W_1L_1 + W_2L_2 - T - P_1Q_1$, namely the difference between after-tax wage earnings and expenditures on consumer goods. The "ruble overhang" represents the summation of "forced" savings over all years. In fact, the black market already absorbs part of the ruble overhang. This is a form

macroeconomic imbalance is the disproportionate allocation of total output to military and investment goods at the expense of the production of consumer goods. Soviet workers are paid in cash (rubles) to produce the entire national output but their options for spending their earnings are limited by the relatively small percentage of aggregate output devoted to the production of consumer goods and services. The inability of Soviet planners to match after-tax cash earnings with the value of available goods and services creates a chronic shortage of consumer goods and consequently, an excess stock of rubles (the ruble overhang) which is accumulated in the form of household cash hoards or savings deposits. The partial liberalization of central planning has loosened the government's ability to control the wage fund which has grown dramatically relative to the output of goods and services. Excess rubles are accumulated in the form of cash and savings deposits. Both are poor stores of value since controlled nominal returns are less than inflation, making real interest rates negative. At the present time household savings deposits total R338 billion¹⁹ and the unknown quantity of currency in circulation in the hands of the public is believed to range between R100 and R300 billion.²⁰ The stock of rubles is presently between 1.1 and

of disguised inflation. It also gives rise to the "criminality" that Soviet leaders widely denounce. What they often fail to realize is that it is precisely the system of price controls that creates these opportunities for monopoly profits. The replacement of centrally administered price controls with market clearing prices, would eliminate both queues and the incentives for this type of underground activity.

19. Annual Statistical Report of the Soviet Union for 1989, reported in *Pravda*, January 28, 1990.
20. Despite glasnost (openness), the Soviet Union remains one of the few countries in the world which does not publish the amount of currency in circulation with the public. This statistic is readily

1.6 times the annual retail sales of the Soviet Union.²¹ This monetary overhang represents a massive inflation potential as excess rubles are exchanged for the diminishing supply of goods and services. This inflation potential can best be checked by institutional changes that permit the ruble to be exchange for real and financial assets, that is, to make the ruble a domestically convertible currency.

Creating a Fully Functioning Monetary Unit

Unlike fully convertible currencies in western nations, the ruble is an archaic pseudo-currency. Its medium of exchange function is severely circumscribed by both foreign and domestic inconvertibility. The ruble can neither purchase foreign currency²² nor can it be used to purchase domestic assets. Even its convertibility into domestic goods and services is severely restricted by the inequitable and inefficient dual distribution system that plagues the Soviet economy. Access to many goods and services is determined by privilege, not rubles. The combined effect of state subsidized prices and limited access to goods and services at these prices has produced

calculated by summing the annual difference between note issue and note destruction. Issue and destruction statistics are normally among the most readily available and reliable statistical data collected in any nation, owing to the security precautions that must be undertaken when notes are printed and redeemed from circulation. Any estimate of the inflation potential of price reform requires data on currency in the hands of the public.

21. Recent Soviet estimates (Petraikov 1990) put the volume of "forced savings" at "roughly 165 billion rubles."
22. An exception is the recent innovation of ruble auctions. These auctions valued the ruble at only \$.05. The official rate of exchange is R1 = \$1.62 and the recently adopted tourist exchange rate makes R1 = \$.16.

an illegal but widespread underground economy in which exchange often involves barter trades.²³ The ruble's effective convertibility is therefore confined to the limited quantity of state goods and services sold at controlled prices, to the high priced goods and services produced by the fledgling cooperative (private) sector, and to goods resold at black market prices in the underground sector.

Enterprises also face an inconvertibility problem because only rubles can be used to make wage payments. All other enterprise expenditures must be made on a non-cash basis, through the use of credits of the state banking system. Enterprise credit funds are themselves largely inconvertible since they must be used in accordance with the central plan, and if thought to be excessive, are often taxed away. Aggregate monetary imbalance and inconvertibility induce the hoarding of consumer goods, capital equipment and the forced savings of rubles (Birman 1980).

It is now well understood that macroeconomic balance assuring stability of the general price level must precede the introduction of market mechanisms and price reforms (McKinnon 1989). Otherwise, relative price signals would be swamped by general price increases, robbing them of their information and allocation function. The elimination of the ruble overhang must therefore be the prelude to price reform. The traditional method of absorbing excess rubles is inflation or higher taxation. Taxes can be explicitly levied on incomes and savings deposits or implicitly imposed by wage reductions. Neither is a politically acceptable alternative in the Soviet Union because both involve expropriation. How then can

23. The limited function of the ruble as even a medium of exchange largely explains the extraordinary hoarding of goods and the fact that "the inventory intensity of our material production (USSR) is almost three times higher than the inventory intensity of the entire American economy" (Shmelev and Popov 1989, p. 134).

monetary equilibrium be achieved without permitting massive inflation?

A direct solution is to enhance the ruble's status to that of a fully functioning monetary instrument. To attain the status of a normal currency, the ruble must be permitted to serve as genuine medium of exchange, fully convertible into goods as well as real and financial assets. The problem of the ruble overhang is not that there are too many rubles; it is that there are too few goods, and more importantly, too few assets that rubles can purchase. Increasing the supply of goods is now high on the agenda of Soviet policy. Indeed, the central aim of the Ryzhkov plan is to divert planned expenditures away from investment goods toward the production of consumer goods. But these reallocations toward the consumer sector will take time, and even if successful, can only have a minimal effect on reducing the size of the ruble overhang.

The most direct and efficacious means of eliminating the ruble overhang is to change the institutional arrangements governing property rights in the Soviet Union. A socialist privatization program that extends asset ownership rights to private citizens increases the menu of real and financial assets available to the public. This decreases the demand for inventories of goods and real capital assets as stores of value, and makes these idle stocks available for consumption and use in production. It also increases the demand for rubles for the purchase of real and financial assets. Making the ruble a truly functioning monetary unit facilitates monetary balance by increasing the demand for rubles while simultaneously reducing their supply. It can, therefore, stabilize the general price level even as relative prices are freed to seek their market clearing levels.

Fiscal Balance

The elimination of future inflationary pressure will also require fiscal balance, namely the reduction or elimination of fiscal deficits. Deficit reduction requires increased revenues and reduced expenditures. In the program described below, the government retains a share of the nation's assets in order to provide it with a non-tax revenue source that increases *pari passu* with the success of reforms. These revenues will need to be supplemented with a general value added tax, special excise taxes and pollution taxes.²⁴ Expenditure reductions will require smaller investment and military outlays. The replacement of central planning with market mechanisms will significantly reduce expenditures by cutting government payrolls, suspending subsidies to unprofitable enterprises, and eliminating existing subsidies on goods.²⁵ These changes alone might be sufficient to eliminate the current deficit.

Unemployment

Any major restructuring aimed at long term improvements in efficiency and productivity entails short term labor and capital reallocations that necessitate the transitional unemployment of resources. Undeniably, unemployment rates will rise, with consequent short term

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24. Income taxes should be kept to a minimum both to avoid supply side disincentives and to reduce incentives for non-compliance. Under the current system of taxation on state enterprises, individual non-compliance is so negligible that tax evasion is not even cited as a specific offense under Soviet criminal law. See Feldbrugge (1989).
 25. Food subsidies are estimated to cost the government some sixty billion rubles per year, roughly the size of the 1988 budget deficit. CIA SOV 88-10043U (1988, p. 12).

output losses. But the expected increase in frictional and structural unemployment that is normally associated with any dynamic economy may be offset by a significant reduction in queue time brought about by market clearing prices. Soviet sources have estimated that some 32 million man-years representing 25 percent of total annual employment are spent each year in shopping.²⁶ While only a portion of this total effort represents absenteeism, the real cost of these queues is lost output and is therefore comparable to unemployment costs in western economies. The elimination of queues entails a positive supply effect that provides a counterweight to increased transitional unemployment. Short run excess labor can be directly employed to rebuild the crumbling distribution system, most importantly the rail and road network.

Resource Mobility and Infrastructure

Short term adjustment costs can be minimized by establishing institutions that promote resource mobility, insurance protection, and efficient allocation in the exchange of goods, factors of production, assets and information. Mobility of resources is enhanced by private property rights that foster contractual sales protected by recourse to legal remedies. Insurance protection is afforded by privately owned assets that can be used to cushion transitional unemployment. Efficient resource allocation requires that exchange be guided by the information and incentive content of prices established by markets rather than by administrative control. The precursors of markets are property rights establishing ownership and guaranteeing control over the disposition of property including limited liability, torts, contract protection and debt creation. Markets must be sufficiently unfettered to encourage freedom of entry so that new

26. Source: *Literaturnaia gazeta*, as reported in CIA: SOV 88-10043U September 1988, p. 11.

firms can compete with existing monopolies. Enterprises must be forced to relinquish subsidies in order to assure freedom of exit through bankruptcy. Market processes must be lubricated by financial intermediation of savings and investment through the institutions of central and commercial banking and equity markets.

The absence of the institutional infrastructure required to support truly competitive markets is cited as a justification for a policy of gradualism. The alternative is to move rapidly to introduce reforms and permit institutions to evolve in a "learning by doing" manner. The former risks the loss of credibility and momentum for the entire reform effort, the latter increases the costs of short term disruptions. On balance, the more radical strategy is more likely to lead to longer run success if coupled with a socialist privatization program that gives each citizen a direct stake in the learning by doing process.

The Mechanics of Socialist Privatization

The programmatic design of socialist privatization must be consonant with long term macroeconomic and microeconomic objectives. These include the achievement of monetary and fiscal balance, the efficient provision of public and private goods, and an equitable distribution of income and wealth.

The implementation of socialist privatization requires the passage of laws on property rights and the creation of institutions to facilitate the economic activities of the reformed system. The most important legal requirement is the adoption of constitutional grants and guarantees to the right of private ownership and control over real and financial assets. Once the legal grounds for socialist privatization are secure, it is essential to create a central banking system capable of exercising overall monetary control, and an extensive network of retail and commercial banks to provide the nation with the financial services required by a fully functioning monetary system.

The creation of the banking system would be accelerated by enlisting the expertise and participation of established foreign banks and international financial organizations. Since political time horizons are short, the provision of rudimentary banking services can initially be established through the postal system which reaches every populated area of the Soviet Union. The post offices can become the foundation of a branch banking network offering basic deposit and loan services.

The banking system's initial functions would be to establish private ownership titles to assets distributed by the state, provide deposit facilities and grant loans against newly acquired privately held collateral assets. The state's custodial assets would be sold at nominal prices set at a fraction of the asset's expected market value. The prices must be set low enough to assure a high real rate of return on the assets in order to provide sufficient incentives for citizens to voluntarily participate in the nationwide privatization program. As reforms progress and true asset values become established, asset appreciation permits the gradual expansion of loans (fully secured by asset collateral) to cushion any dislocation engendered by the reform process.

Creation and Distribution of Citizen Shares

The socialist privatization of some 46,000 state enterprises requires that they be reconstituted as corporations with limited liability. Corporate ownership would be evidenced by title to tradeable equity shares in each of the currently operating enterprises, entitling the owners of the shares full participation in dividend distributions and capital appreciation of the enterprises. The shares must also be saleable on equity markets. For simplicity of exposition, we shall initially consider a bundle of equity shares consisting of an equal fractional ownership share in each and every state enterprise. We shall call this bundle a "citizen share." The distribution of citizen shares

constitutes the most essential feature of socialist privatization, the rational pluralization of property.

The principles guiding the distribution of citizen shares are equity, efficiency and democracy. The equity principle assures a distribution of state assets that will afford each citizen the opportunity to share equitably in the consumption of both public and private goods. The efficiency principle seeks to insure that ownership rights are distributed so as to encourage efficiency in the production of both public and private goods.²⁷ The democracy principle assures each citizen a voting right to determine the appropriate mix of public and private goods provision.

A provisional suggestion is to distribute the bundled citizen shares in the following manner: 10 percent to the central government; 20 percent to the Soviet republics; 50 percent divided equally among all Soviet citizens. These shares could be specialized by assigning different voting rights to different classes of stock. All shares allocated to citizens retain full voting rights. The class of shares allocated to the government would either be non-voting, or limited tenure voting shares.²⁸ The remaining 20 percent

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27. The socialist privatization scheme involves a separation of ownership and control similar to that found in most western economies. Two mechanisms provide significant ownership groups with the ability to monitor management. First, a portion of the initial distribution is earmarked for managers, workers and foreign investors with direct stakes in individual enterprises. Second, the plan anticipates the emergence of mutual funds that specialize their asset portfolios. The mutual fund managers, acting as agents for citizens, will have direct incentives to exercise their proxy ownership rights to oversee management decisions.
28. Since government shares represent a concentrated block, the determination of their voting rights represents a critical policy decision. Voting rights on government shares could be stipulated to automatically decline during a five-year transition period and fully lapse thereafter. For example, each government share's voting right

are unbundled, with individual enterprise voting stock allocated to workers, managers and foreign investors, as will be explained below.

The initial distributions between citizens and public authorities could be subsequently modified by public referendums. A simple instrument for evaluating the adequacy of public goods provision by government authorities would be to grant citizens the periodic right to vote for a marginal increase or decrease in the allocation of citizen shares to central and regional authorities. This mechanism would be designed to give the public an opportunity to vote to increase or decrease taxes while maintaining a balanced budget constraint. Citizens would, in effect, democratically determine the degree of economic privatization they desire by voting to change the allocation of citizen shares between the government sectors and the private sector.

Shares for the Central Government

The allocation of 10 percent of citizen shares to the central government enables the state to discharge its monetary and fiscal responsibilities. The asset side of the government's balance sheet would consist of its portfolio of citizen shares. These assets would provide the backing for the issue of interest and non-interest bearing government liabilities that can be sold by the central bank to commercial banks and the public. Being fully backed by the real assets represented by citizen shares, these government liabilities establish a sound basis for executing monetary policy through open market operations by the central bank. Moreover, the equity shares in government

could become fractional with the passage of time. As markets, stock exchanges and financial intermediaries evolve, the government's role in management decisions would automatically decline.

hands provide a source of fiscal revenues that reduces its reliance on other distorting taxes.

Under this scheme the government would use its dividends from citizen shares and other tax revenues²⁹ to provide public goods, most important among these, national defense, central government services and debt service. Fiscal discipline is imposed by requiring that government debt be fully backed by the government's reserves of citizen shares. In short, the central government's holdings of citizen shares provides both a source of government revenue and a real asset based anchor for monetary issue.

In capitalist fiscal systems, government revenue is assured by granting the government the coercive power to appropriate a portion of the future incomes streams accruing to its citizens in the form of taxes. Under socialist privatization, the government is granted the right to own titles to a portion of the nation's assets outright, thereby providing it with an independent revenue source. Essentially, the government's portfolio of equity holdings represents the capitalized value of the income stream it would otherwise have to appropriate from its citizens in the form of taxes. Similarly, in capitalist monetary systems, the credit worthiness of the government is established by lenders' perceptions of the government's ability to sustain its coercive power to appropriate sufficient income from its citizens to service its debt. Under the socialist privatization program, the government's credit worthiness is assured by its outright title to a portfolio of national assets that serves as direct backing for its issue of government liabilities.

29. Other sources of government revenues would include special commodity taxes such as the present tax on alcohol, value added taxes, environment pollution fees and other use taxes. Income taxes could be kept to a minimum as a supply side spur to productivity.

Shares for Regional and Local Governments

The 20 percent of citizen shares distributed to regional governments is stipulated to provide those authorities with a national revenue base for public expenditures. These social expenditures would include health, education, welfare, environment, and infrastructure, the composition and amount to be determined through the democratic political apparatus governing each of the republics. Each republic will be encouraged to allocate a portion of its shares to lower level local authorities. As with the central government, the regional governments would be entitled to issue liabilities in the form of interest bearing bonds up to an amount not to exceed the market value of its citizen shares. Independent auditing of the books of the regional governments will be the responsibility of a body appointed by the central government to assure the liability constraint.

The regional government distribution establishes autonomous political control for the allocation of public expenditures while maintaining a binding macroeconomic constraint on the overall size of public expenditures.³⁰ The reallocation to local governments permits diversity in the choice of public goods and services and assures local citizen control over those services that most directly affect their well-being.³¹ The grant of asset titles to regional governments would help to satisfy public demands for greater regional autonomy and would serve to decentralize the bureaucratic controls that now stifle reform efforts.

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30. The regional share distribution serves to avert the political disintegration of the Soviet "internal empire" by granting growing demands for economic autonomy in the disbursement of revenues, while collecting these revenues from a shared national asset base.
31. Local government services typically include police, fire, zoning, education, environment and judicial services.

Shares for the Public

The socialist privatization program envisions that 50 percent of all citizen share bundles be distributed in equal shares, to each and every citizen. In the Soviet Union, rough calculations suggest that the per capita share value of this distribution may be two or three times the average per capita annual income of the Soviet citizen. Each citizen will be enabled to purchase his or her share entitlement at a nominal cost through a nationwide share registration program. The nominal cost of the shares should be set at the lowest possible fraction of the forecasted market value of the shares consistent with the achievement of monetary balance.³² The idea is to use the share distribution to absorb and sterilize a sufficient amount of excess rubles to restore the monetary equilibrium required for overall stability of the price level.

Given the current level of earnings and the skewed distribution of wealth in the Soviet Union, many citizens may not have sufficient liquid savings to directly purchase shares even at the low nominal price.³³ Citizens without

32. It should be recalled that the *total* stock of outstanding rubles in savings deposits and in circulation with the public is estimated to be between 50 and 75 percent of GNP. Once the ruble is reconstituted as a fully functioning money, the demand for rubles will be stronger than now and therefore the excess supply of rubles will be only a small fraction of the total amount outstanding. Because the citizen shares represent the capitalized value of a future income stream, the monetary balance constraint can be readily attained at a share price that is only a fraction of the expected market value of shares.

33. Soviet sources suggest that the present distribution of savings deposits is highly skewed, with 3 percent of the population holding 50 percent of savings deposits. Seven of eight Soviet citizens are reported to have no savings at all. Central Intelligence Agency, SOV 89-10035 (1989, p. 6, fn. 14). However, Soviet statistical reports suggest that in 1988 there were almost 200 million deposit accounts. *Soviet Union in Figures 1988*, State Committee on Statistics (1989, p. 69).

requisite means would be entitled, upon registering their shares, to establish a bank deposit account and receive a loan to aid in the purchase of their citizen share. The citizen share itself would serve as loan collateral. The interest rate on the loan would have to be set above the interest rate on ruble deposit accounts but below the expected rate of appreciation of the citizen share. This rate structure would provide an incentive to pay for shares with available rubles rather than through the loan mechanism.

Most Soviet citizens are unaccustomed to banking facilities. The citizen share distribution program must therefore be accompanied by a massive public education program to explain the rudiments of personal banking practice. While this seems a daunting task, it is precisely the type of clearly defined centrally directed objective which the Soviet system of central planning is best at accomplishing (Ericson 1989, p. 25).

The proposed citizen share distribution serves several reform goals simultaneously:

- It institutes a painless ruble absorption mechanism for establishing monetary balance without having to resort to inflation or direct taxation.
- It establishes an egalitarian asset distribution, providing each member of society with a direct stake in the successful outcome of the reform process, while providing each citizen with income earning assets that serve a safety net function to cushion the dislocation effects of reform.
- The administrative process of share distribution and registration facilitates the institution of a nationwide banking system that provides basic deposit and loan services. As such, it performs an indispensable function of introducing and educating the public in the use of basic banking facilities.

*Shares for Workers, Management and Foreign
Investors: Equity Pricing and Incentives*

Three interdependent problems remain to be solved. First, how are citizen share equity values to be determined? Second, how can we assure adequate incentives for workers and management to strive for productive outcomes if management and ownership are largely divorced? Finally, how can we achieve ruble convertibility for international currencies?

Each of these issues is addressed by the proposed distribution of the remaining 20 percent of the nation's citizen shares. In an economy without any history of equity markets and hence no experience in share valuation, it is necessary to enlist the talents of those individuals most likely to possess relevant information and skills appropriate to the task of asset valuation. It will be recalled that each citizen share is composed of a bundle of disparate shares of separate economic entities. The shares of each separate entity therefore need to be priced before it is possible to determine a composite market valuation for a citizen share.

Market pricing of unbundled equities of specific firms can take place only after financial and price reforms have been enacted. Financial reforms require the elimination of subsidies to unprofitable firms by the earnings of successful firms. This necessitates the replacement of "soft budget constraints" by "hard budget constraints" (Kornai 1986, McKinnon 1989). Under these circumstances, some of the enterprises represented in the citizen share bundle will no longer be viable, and bankruptcy provisions must be established for these enterprises. Successful firms, no longer burdened with the taxes required to subsidize ailing firms, will show increased profits and new entrants will be attracted to these lines of business. Reforms must therefore provide for exit of failing enterprises and must encourage the entry of new firms into profitable business areas. Ownership rights in any new

firms that substantially benefit from the dissolution, reorganization or asset sales of existing firms must be distributed in accord with the initial socialist privatization plan. This assures that neither the government nor the public will suffer a dilution of its equity interests as a result of a revaluation of assets at less than their market value.

Proper valuation of equity shares requires that investors have sufficient information to form reasonable expectations about present and future profits. This in turn requires projections of input costs and output prices. While central planning authorities already establish relative prices for goods and factors of production, these prices typically do not reflect true scarcity values or opportunity costs. Nor do they flexibly respond to changing economic circumstances. If relative prices are to convey both appropriate information and incentive signals, major efforts must be undertaken to break up existing monopolies into smaller competitive enterprises. Once this is accomplished, centrally controlled prices must be set free to clear markets. This represents a constrained big bang approach to reform. Prices of goods regularly traded on international exchanges could initially be set to conform with international market prices so as to minimize the distorting effects of residual monopoly power in some industrial sectors of the USSR. All other prices should be set free to seek their market clearing levels.

Price controls are best eliminated all at once rather than by the more timid, and more distorting, method of step by step reform. This is particularly true when price reforms are preceded by a program of socialist privatization that serves both to speed and buffer the adjustment process. The prior establishment of monetary balance permits market determined relative price changes to quicken the pace of resource allocation since relative price signals are not contaminated by increases in the general price level. The elimination of central planning directives and bureaucratic controls significantly reduces transaction costs of exchange. The dispersed holdings of

property rights serves to pool risk and provide an asset buffer that enables individuals to withstand the disruptive consequences of transitional unemployment. In short, socialist privatization helps to speed the adjustment process initiated by the big bang while cushioning its transitional impact. It is the newly distributed asset shock absorber and the established monetary stability that contains the explosive forces of the big bang.

With relative goods and factor prices approaching, however roughly, their market clearing values, it is possible to value equity shares. Initial equity prices of individual enterprises are established at open public auctions of the undistributed shares representing 20 percent of the original share issue. The richest source of information relevant to the pricing of equity shares of any particular enterprise resides with its managers and workers. The richest source of skills for valuing equity shares is to be found in the international financial and entrepreneurial community. It is therefore essential that both of these sources be given incentives to enlist their knowledge and skills to attain appropriate share valuations at the public auctions.

Managers and workers in particular enterprises serve an additional vital function. It is their specific efforts that will determine the efficiency with which enterprises operate. It is therefore essential that they be provided productivity incentives that contribute to the public interest (as represented by the shareholders of the initial distribution). To enlist their information advantage, and to stimulate their operational talents, workers and managers of every separate enterprise should be given a right of first refusal to purchase 10 percent of their unbundled enterprises' outstanding shares at the prices determined by public auctions. Similarly, international financial entrepreneurs are offered an inducement to participate in the share pricing process by giving them the right to purchase up to 10 percent of the remaining outstanding shares at the public auction prices.

The proposed procedure would accomplish the three interdependent goals. The nation's equities would be priced by engaging the talents of those most able to assess their market value. Management and labor of particular enterprises now have an equity incentive to increase the efficiency, productivity and profitability of their enterprise. Foreign investors are given an incentive and opportunity to purchase shares of particular enterprises, giving them a direct interest in the sound restructuring of management practices. Their participation introduces the flow of new capital and new technologies. Foreign investors would be required to purchase shares with rubles, which in turn must be purchased with foreign currency. Since most of the excess rubles would have been soaked up by the sales of assets to Soviet citizens, the foreign demand for rubles to purchase Soviet assets will raise the international value of the ruble. The foreign currency reserves created through the sale of assets to foreigners, in combination with the asset backing of the ruble, should be sufficient to establish the ruble as a *de facto* international convertible currency.³⁴

34. W. Angell (1989) and D. Gressel (1989) have proposed specific plans for establishing international ruble convertibility. The Angell plan involves a gold backing for the ruble to provide an internal monetary anchor. The Gressel plan involves a foreign currency fund reserve for the ruble, thus providing an external anchor. The socialist privatization program represents a hybrid solution. A ruble backed by the real assets of Soviet economy as evidenced by citizen shares represents another type of internal anchor. The sale of enterprise shares to foreigners establishes a domestic fund of foreign currency reserves that can be used to allow profit repatriation in much the same manner as an external anchor. A fuller discussion of the ruble convertibility issue is found in Feige (1990b).

Housing and Land

The state currently owns almost three-quarters of the nation's housing stock, which is heavily subsidized with low rents. These rental subsidies have several highly undesirable consequences. At the macroeconomic level they contribute to fiscal deficits. At the microeconomic level they create a chronic excess demand for housing that further reduces the mobility of an already immobile labor force. Since citizens do not presently have property rights to their apartments, maintenance of the housing stock is poor, and it quickly becomes dilapidated.

Each of the above problems can be ameliorated by privatizing the housing stock³⁵ while simultaneously eliminating rental subsidies (except those provided to elderly pensioners) and providing long term mortgages for prospective apartment purchasers.³⁶ Higher rental rates, combined with moderate mortgage interest rates and rights to resell property, would establish adequate inducements for many citizens to choose ownership over tenancy. Current apartment renters would be offered the opportunity to purchase their own apartments with the full right to renovate and resell the unit on the newly established unregulated nationwide housing market. Ruble proceeds of down payments from the initial sales would be demonetized in order to reduce further the ruble overhang. Rental subsidies and maintenance expenditures of the state would decline *pari passu* with the increase in private purchases, thereby improving fiscal balance. Worker mobility would increase as fully transferable

35. According to the *New York Times* (May 21, 1990, p. A1), "President Mikhail Gorbachev today opened a new campaign to turn marketplace economics against intractable consumer problems, directing the Government to let private individuals build, buy and sell their own houses and own the lots on which they stand."

36. A similar proposal has been suggested by Desai (1989).

property rights replace the present privilege system of housing allocation. The increased labor mobility would ease transition adjustments by shortening periods of transitory unemployment required by labor force relocations. Finally, the establishment of property rights, combined with the removal of rent subsidies and restrictions on entry into the construction industry, produces a powerful supply side incentive for private sector housing construction to alleviate current housing shortages.

In the agricultural sector, incentives for productivity and sound ecological land use are established by the extension of full private property rights to agricultural land, permitting individuals to capitalize future income streams. The development of rural banking networks that accompany the initial socialistic privatization distribution form the basis for loan arrangements that can be used for the purchase of land for agricultural use. In time, citizen shares can be sold, with the proceeds being used for the individual or collective acquisition of land in the rural sectors.

Establishing and Maintaining Confidence in the Transition Process

The Citizen Share Index

As soon as initial equity values for specific shares have been established by auction, the Soviet stock exchange would open for public trades. The daily stock exchange index value of a "citizen share" – the Soviet equivalent of the Dow Jones index – would be prominently published in every Soviet newspaper and serve as a visible indicator of the progress of perestroika's reforms. Confidence in the reforms will be bolstered by rising share values and a steady stream of dividend payments to share holders. Rising equity values are likely because the equity market will be initially structured as a positive sum game.

During this crucial period, some firms will fail and become bankrupt while others will flourish. The citizen share will reflect both tendencies and these pooled risks will be shared by both the government and its citizens. Nevertheless, the aggregate value of citizen shares is expected to appreciate substantially during this time. This appreciation is assured by the low initial cost, the elimination of current mismanagement practices,³⁷ and the efficiency and productivity gains brought about by the improvement in information and incentive systems. Every upward movement of the citizen share index helps to build confidence in the success of the reforms. The confidence will be reinforced by permitting gradual increases in loans that can be used to acquire other sources of real property such as land, apartments, capital and equities.

Dividend Distributions

During the initial phase of the transition all enterprises would be required to pay out their profits in the form of dividends which would be credited to the bank accounts established under the initial socialist privatization distribution. Firms' investment requirements would be financed by loans through the banking system whose function is to provide intermediation services between savers and investors. The external finance requirement provides a means of enforcing hard budget constraints as enterprises are forced to operate in a commercial banking environment. Both the equity and debt markets will establish positive real interest rates, thereby creating a meaningful channel for the allocation of savings to investment, over space and time.

37. A major efficiency improvement will result from the elimination of redundant inventories that are now rampant in Soviet enterprises.

Shortage Reductions – Supply Side Effects

Continued confidence in the success of reforms will also require a visible reduction in shortages of consumer goods and services. Aggregate demand will be reduced by the elimination of the ruble overhang and the use of rubles to purchase available stocks of real assets. Shortages of individual goods are eliminated by the introduction of market clearing price mechanisms. In addition, there must be an increase in the supply of consumer goods and services. Ruble convertibility will encourage the dishoarding of inventory stocks and improve prospects for imports of consumer goods. The reallocation of military and investment expenditures to consumer goods will also help to improve available supplies. Unconstrained market prices will provide information and incentive signals for the entry of new enterprises into consumer markets. Private ownership rights and price incentives are likely to induce improved productivity in both industry and agriculture.

Further Safeguards

In the initial stages of reform, certain safeguards will also be necessary to preserve the integrity of the Soviet citizen's nest egg. Because the populace of the USSR is unfamiliar with the workings of financial markets, there will be a learning period during which it would be desirable to protect the financially unsophisticated public from unscrupulous business dealings.³⁸ In order to avoid

38. Czechoslovakia is considering a privatization scheme that would allocate vouchers to citizens that could be used to bid for shares of state enterprises slated for privatization. A voucher distribution system appears to satisfy the egalitarian distribution aspect of the socialist privatization program outlined here. However, it fails to take account of the fact that information is asymmetrically distributed among the population. The asymmetric information problem can be readily circumvented by distributing bundled

this "carpetbagger" problem, a non-alienation clause, in force for the first five years of the transition, would prevent the initial asset distribution from becoming skewed. During this period there would be a prohibition on any asset transfer that alienates a citizen from his claim to the market value of his citizen share allocation.³⁹ Such a restriction could be combined with loan collateral requirements that would limit commercial bank loans to a fraction of the market value of a citizen's shares. The daily citizen share index would serve to establish the collateral value of each citizen's borrowing rights in the banking system. The right to borrow would be permitted to increase in direct proportion to the citizen share index and the loan margin could gradually be increased during the transition period. As the economy becomes more efficient, productive and responsive to consumers' preferences, monetary conditions would adjust to the needs of trade.

citizen shares rather than vouchers. Each citizen, regardless of their financial sophistication, becomes a residual claimant to the capitalized value of expected income streams from all existing state enterprises. Those citizens with specialized knowledge concerning a particular enterprise will participate in the auction of 20 percent of the unbundled enterprise specific shares. The residual claimants of these shares will indirectly benefit from the specialized knowledge of auction participants as reflected in the share valuations.

39. The guarantee of a vested claim in the market value of a citizen share does not preclude the possibilities of these shares being unbundled and traded in capital markets. A variety of financial institutions and financial instruments would serve these ends. Insured mutual funds, managed as joint ventures with foreign investment expertise, could specialize in financial management and trades of unbundled citizen shares. Fixed interest debentures, convertible into citizen shares, could assure both steady income streams and options to realize appreciation in the underlying citizen share bundle.

Retrospect and Prospect

Mikhail Gorbachev's vision for restructuring the Soviet Union rests on three interdependent pillars: international initiatives, glasnost and economic reform. The intent of these respective reforms is to reduce international tensions, extend political democracy and create a dynamic and prosperous economy. Each pillar of Gorbachev's policy package represents a necessary but not a sufficient condition for the realization of peace, democracy and economic rejuvenation. A failure of any one of these structural policy elements weakens the other two, and threatens to transform this hopeful yet fragile circumstance into an unstable situation with the gravest domestic and international consequences.

The polities of East and West have acknowledged and welcomed Gorbachev's foreign policy initiatives to ease international tensions. There is international enthusiasm for the unexpectedly rapid extensions of political freedoms. The stage is set for mutually beneficial substantive reductions in both strategic and conventional force levels. The embrace of glasnost and the easing of international tensions has, however, deflected attention from the weakest and most critical component of Gorbachev's perestroika – the policy of economic reform.

Step by Step

To date, the Soviet leadership has not produced a clear vision of where economic reform is going, and failing that, has not mapped a consistent transition plan for getting there. The undercurrents of the debate reflect a fundamental intellectual struggle between the newly emerging ideas of economists, clashing with the well

entrenched views of engineers.⁴⁰ Engineers espouse "price reforms," meaning yet another attempt to recalibrate the price structure to get "prices right." They have yet to acknowledge the need to replace the ossified central planning mechanism with a system of competitive markets. Moderate economists advocate the creation of a "socialist market" (the Abalkin report) or a "regulated market" (N. Ryzhkov, *New York Times*, May 25, 1990, p. A8), failing to concede the contradiction between administered prices and those set by markets. The more radical economists now recognize that "there is not indeed any alternative to the market" (N. Petrakov, *Pravda*, April 26, 1990, p. 2). They now acknowledge that "pluralism of property" must explicitly extend the right to private ownership as a necessary prerequisite for markets to function.⁴¹

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40. Economists are trained to solve the problem of allocating scarce resources to *alternative* ends, whereas engineers are trained to allocate scarce resources to a *single* end. When the objective of social policy is centrally determined by the vanguard, social engineering skills are required to solve the problem of allocation. The introduction of pluralism inevitably creates alternative ends, requiring economic skills to determine appropriate tradeoffs.
41. S. S. Shatalin has forcefully expressed this view in a *Pravda* interview of April 26, 1990 (p. 2): "The problem of ownership is not a question of academic philosophizing. It is a question of whether we can begin free enterprise tomorrow. The economy only begins to breathe if real owners appear. But in our country both the new laws and the party's congress platform proceed on the premise of the predominance of state ownership. We proceed on the 'presumption of innocence' of state ownership. But it does bear blame. For the fact is that we are bankrupt. We now want all other types of ownership to prove that they are no worse. Although private ownership has already shown its social usefulness worldwide, our state ownership has proved that it can bring the country to 'the end of its tether.'"

Political fear of popular reaction to bold reform measures has produced ambiguity concerning the transitional path toward a market economy, resulting in a tepid step-by-step approach to restructuring. The unexpected negative consequences of these well-intentioned piecemeal efforts are best characterized by Lenin's famous phrase, "one step forward, two steps back."⁴²

The much heralded anti-alcohol campaign to improve productivity, significantly reduced a major source of government revenue, thereby aggravating budget deficits. In its wake it left a bootlegging industry, higher alcohol prices and sugar shortages.

The campaign against unearned income, launched to expose the widespread abuses of theft, bribery and underground economy activities, failed to identify the systemic failures of central planning that induced such activities. It served instead to discredit and slow the development of legal market activities that could replace perverse incentives (Belkindas 1989).

The Law on State Enterprises sought to improve efficiency by loosening the restrictions imposed by central planning. The law gave greater leeway to state enterprises by encouraging "self management" and "full cost accounting" practices. But, in the absence of meaningful price reforms, the partial relaxation of controls created new perverse incentives to lower output quality and raise prices. Goods were increasingly distributed by privilege and black market channels. As a result of these partial relaxations, the government lost control of the money

42. The Five Year Plan put forward by Prime Minister Nikolai Ryzhkov represents a retrenchment from the more far-reaching reform proposals put forward by Deputy Prime Minister Leonid Abalkin. The Ryzhkov proposal contemplates a continuation of the "diktat" system of centralized controls. Its main innovation is the redirection of planned investment expenditures (primarily in heavy industry) toward increased production of consumer goods.

supply which has been expanding at a much greater rate than production.

Similarly, the Law on Cooperatives, widely heralded in the West as an opening for entrepreneurship and private enterprise, permitted only a limited number of firms to operate in shortage markets. These firms, not surprisingly, charged prices that the market would bear, and thereby made huge monopoly profits whose exposure aroused public indignation resulting in confiscatory taxes that further served to discourage entry. The Law on Cooperatives also created loopholes in the central control of the currency supply. These ruble leakages exacerbated macroeconomic imbalances. Repressed inflation became open inflation while new fuel was added to overall inflationary pressures. The cautious piecemeal relaxation of controls has consistently produced unanticipated counter-productive consequences.⁴³ As a result, step by step, perestroika has become its own worst enemy.

The announcement of perestroika created public expectations that have now been shattered by the spread of shortages and economic dislocations. Conservative critics have taken advantage of public disillusionment to skillfully deflect Gorbachev's insightful criticism of the systemic failures of the "diktat" system of central controls. Increasingly, it is perestroika that is blamed for the current economic crisis. To an extent, these critiques are justified. But not because reform has been too quick or too radical. It is the sluggish and incomplete nature of reform that is at fault. Unless radical economic and political initiatives are undertaken to reverse the current deterioration, economic reform, the weakest and most critical buttress of Gorbachev's perestroika, is in danger of collapsing.

43. R. Ericson (December 1989) formally demonstrates the inherent difficulties of attempting to decentralize the implementation of central plans. Similarly, K. Osband (November 1989) demonstrates the inherent instabilities of policies which relax wage controls while official consumer prices remain fixed.

Despite the rhetorical and substantive changes that the Gorbachev era has inspired, the structure of the Soviet economy remains a quagmire of hierarchical organization of centralized ownership and control, characterized by inflexible prices, monopolized industries, rudimentary monetary and credit institutions, inconvertible currency, distorting taxes, and incomplete and often misleading information and incentive mechanisms. These moribund economic institutions have left in their wake an economy racked with inefficiency, low productivity, shortage, decelerating growth and open and repressed inflation. It is this malaise that justifies radical systemic reorganization.

The Need for Radical Change

Economic discontent, combined with the persistent pressure from Soviet republics for greater independence, presage a centrifugal disintegration of political union. Alternatively, these pressures may unleash the centripetal forces of Russian nationalism that threaten a "firm hand" retrenchment to stricter economic and political controls. A stable and economically sound Soviet Union represents the best hope for both the socialist countries and the West. Its attainment depends critically upon the initiation and execution of a revitalized program of economic reform.

The radical reformers envision a restructuring of the Soviet economy that necessitates fundamental changes in the economic institutions of the USSR, from a centralized command system of production controls to a decentralized market system. Market mechanisms are to replace planning ministries as the means for allocating and distributing resources. Entrepreneurship is to replace bureaucracy. Flexible relative prices of factors of production and goods and services are to replace fixed planning prices and production quotas. In short, the institutions that now decide what is to be produced, how it is to be produced, and how it is to be distributed are to be decentralized and democratized, radically altering the

mechanisms that govern how decisions are reached, how information is gathered and disseminated, and how incentives are structured.⁴⁴

The political problem is how to adopt market mechanisms while avoiding the "nagging and pervasive tradeoff between equality and efficiency" (Okun 1975, p. 2). Both the efficiency and the inequality of market-determined outcomes have made a deep impression on Soviet observers. They now acknowledge that their own privilege system also produces inequality, yet without the benefits of efficiency. The Soviet Union and the nations of Eastern Europe recognize that the economic and political institutions that have guided their past development have failed to accomplish their intended socialist objectives. The purchase of some degree of economic security and equality has come at too great a cost in prosperity and democracy. They now seek a means of achieving the latter without foregoing the former.

Socialist privatization is proposed as a means of satisfying these objectives. It calls for the establishment of democracy by expanding the range of political and economic choice. The means to exercise choice are assured by the dual franchise, the right to vote with ballots and economic resources. Equality of opportunity to exercise choice is attained by making each franchise universal. The universality of the economic franchise requires the establishment of private property rights as well as an egalitarian distribution of those rights.

State ownership of the means of production, and central planning, embody authoritarian-bureaucratic elements that are not consonant with socialist ideals. The class struggle between capitalists and workers can be

44. "We have reached a crucial, some might say critical, stage in perestroika, the restructuring of management in our country Financial reform of the economy is therefore of the utmost urgency . . . it is the key to the whole of the economic reform" (Aganbegyan 1989, p. 1, p. 11).

better resolved by providing all citizens with capital and permitting them to retain the fruits of their labor. Socialist privatization calls for the state to relinquish its stewardship over the means of production and redistribute the nation's assets to its people. A portion of these assets (in the form of citizen shares) is to be retained by a duly elected government to assure a non-distorting source of revenue to provide necessary public goods and services. These assets also serve as backing for government liabilities whose issue is to be strictly controlled. The proposed share distribution to regional governments provides each republic with the autonomy and resources to determine its own public goods provision. The region's share distribution of national assets provides an incentive to maintain union affiliation.

The largest portion of the state's custodial assets are to be divided equally among all citizens by a mechanism that simultaneously serves to create a rudimentary banking system. Workers, managers and foreign investors are given an opportunity to acquire specific enterprise shares in order to attract the resources, skills and information necessary for efficient production and equity valuation.

The first stage of socialist privatization (abdication of state ownership of the means of production) establishes a level and secure playing field as a prelude to the introduction of market forces. The process is designed to circumvent the two major obstacles that threaten the stability of systemic reforms. The sale of custodial state assets to citizens absorbs excess money, thereby eliminating the threat of inflation. The citizen's asset distribution provides an economic cushion to dampen temporary dislocations.

With macroeconomic balance restored, the socialist privatization program goes on to replace central planning with free markets. Price reforms are best undertaken in a single action because step by step approaches exacerbate systemic distortions. Partial reforms erode macroeconomic balance constraints and encourage a dual price system that diverts low priced state resources into criminal markets for

monopoly profit. If firms are to determine rationally what to produce and how to produce it, they require information on the relative prices of factors and outputs. If consumers are to exercise their consumption and savings preferences they must know the relative prices of present and future consumption. And if these prices are to reflect scarcity value and opportunity cost, they must be determined by the forces of supply and demand in free markets. General equilibrium can only be attained when prices are sufficiently flexible to clear markets. In short, reform of the economic allocation system is best undertaken all at once, so that all prices can rapidly seek their market clearing levels. The transitional costs of a big bang adjustment are constrained when monetary balance is assured and buffer assets are distributed before the introduction of price reforms. Socialist privatization ensures these preconditions for a controlled transition.

If socialist privatization is adopted and promptly initiated, it will serve several desirable political and economic needs simultaneously. From a political perspective, an egalitarian redistribution of assets is likely to capture the imagination and energy of the general public. This will provide the Soviet leadership with the support and time needed to proceed with perestroika in an orderly fashion. It also serves to defuse regional pressures by satisfying demands for greater autonomy. Socialist privatization offers an implicit deal to the privileged nomenklatura who are often cited as opponents of reform.⁴⁵ They are permitted to retain what they have procured in the past in exchange for their acquiescence to give up the means of acquiring special privileges in the future.⁴⁶ When faced with public outrage over their past

45. See P. Gregory (1989) for a detailed analysis of bureaucratic responses to perestroika.

46. When past wealth accumulations are spent on equity markets, they serve to drive up the citizen share index, thereby conferring indirect benefit to all shareholders.

favored position, they are likely to consider this arrangement the best they can hope for.

From an economic perspective, socialist privatization removes the monetary overhang, establishes a natural social safety net and creates the institutions required for sound monetary and fiscal policy. The sharing of the state's custodial assets between citizens and the government creates a unique socialist structure that fosters cooperation between citizens and government. Both have a common incentive to promote the success of reforms.

The communist experiment sought to establish a cooperative, equitable, democratic and prosperous society by placing ownership of the means of production in the hands of the state and directing the economy bureaucratically according to a central plan. It is now increasingly acknowledged that the experiment did not succeed in attaining its goals. Yet paradoxically, the failed experiment has created a unique opportunity to salvage its goals by now undertaking a reform program of socialist privatization. By overseeing the return of state custodial property to its citizens and initiating market oriented price reforms, perestroika can directly effect an egalitarian distribution of wealth and create the requisite institutions for genuine democracy and market efficiency.

The Soviet Union's output continues to decline as open and repressed inflation accelerate. The systemic failures of central planning have been aggravated by the gradualism of step by step policies. The conceptual framework outlined here attempts to sketch a final destination for perestroika that reconciles the egalitarian aims of socialism with the efficiency and dynamism of a market economy. The road map proposed for the transition from a centrally planned economy to a market economy anticipates and attempts to circumvent the most serious obstacles along the way. The proposed reforms are comprehensive and inter-linked, designed and sequenced so that separate reform components reinforce one another. Socialist privatization offers a form of radical change that

can reduce, but by no means eliminate, the short-run pain of the transition process. The rapid and wholehearted execution of the socialist privatization program is critical to its success. Translating these ideas into concrete policy implementation requires detailed economic elaboration and great political dexterity. The bureaucracy has the organization and information to provide the former, Gorbachev has demonstrated his ability for the latter.

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