

**ECONOMIC REFORM AND  
INTEGRATION**  
**Proceedings of 1–3 March 1990**  
**Meeting**

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# Summary

## The IIASA Project on Economic Reform and Integration—ERI

In late summer 1989 we were approached by Academician S. **Shatalin** of the Soviet Union, Member of the USSR Presidential Council, with the request to consider establishing an activity that could analyze international economic interdependencies and serve as a scientific forum to support economic reforms in the Soviet Union and the other socialist Member countries of our Institute. In our view, meeting the following conditions was essential in order to be successful:

- active interest and readiness for cooperation among scientists and policy-makers, east and west;
- a readiness among contributing scientists to engage in risky, policy oriented research;
- a working approach which would differ markedly from the usual IIASA style in terms of preparation, participation, intensity, and timing;
- sufficient resources, probably beyond the regular IIASA budget.

Visits with high-level policy makers, such as Deputy Prime Minister **Abalkin** of the Soviet Union; Mr. **Attali**, Special Advisor to President Mitterand; Mr. **Vignon**, Director of the “Central Advisory Group of President Delors, Commission of the European Communities” (Lacroix Group); and Deputy Prime Minister **Reichel** of the ĀSFR convinced us that we could attract major interest and count on support in the policy arena. Academician Igor **Makarov** Chief Learned Secretary of the USSR Academy of Sciences assured us of intensive interest. The IIASA Council warmly approved the Project late in 1989. We have since then received further high-level encouragements from policy-makers in Poland and Bulgaria. Pledges of financial

(hard currency) support were received from a number of countries, including Finland, ČSFR, France, Japan, and the Commission of the European Communities. Cash hard currency contributions were obtained from the USSR, USA, and Bulgaria so far.

## Objectives of the ERI Project

The general aim of the Project can be formulated as *establishing bridges* between eastern and western economic theory and practice, creating conditions for mutually assimilating successful managerial experience, and for possible rapprochement of economic systems.

Two types of **objectives** are the focus of the ERI Project. Objectives of the first type are connected with actual **problems of economic reform** in centrally planned economies and **mutual East–West institutional adjustments**. Objectives of the second type are to produce *methodology* for East–West comparative analysis. The development of methodological tools is to provide a foundation for applied research, and support the preparation of concrete policy recommendations. In the **methodological research**, special emphasis will be placed on:

- The construction of *non-traditional* quantitative indicators for East–West comparative analyses, for the determination of *commons* and *specifics* in socio-economic development in East and West, for the determination of reciprocal influence of different development aspects, for the identification of feasible reform strategies and their assessment;
- The elaboration of methodology for international institutional comparisons, including the creation of relevant quantitative measures.

During a scoping workshop at Laxenburg a major meeting on the subject of accounting measures (including environmental) was approved to be held in Sochi, USSR from 15–17 October 1990.

Among the main goals of the Project's **applied research** are:

- The determination of the most fruitful institutional innovations, the study of accumulated experience in solving social problems, especially in countries where attempts to balance the extent of market regulation were already successful;
- The elaboration of scenarios of different reform options for Eastern Europe, the preparation of recommendations for improving economic

legislation in various countries, and for harmonizing the international economic order.

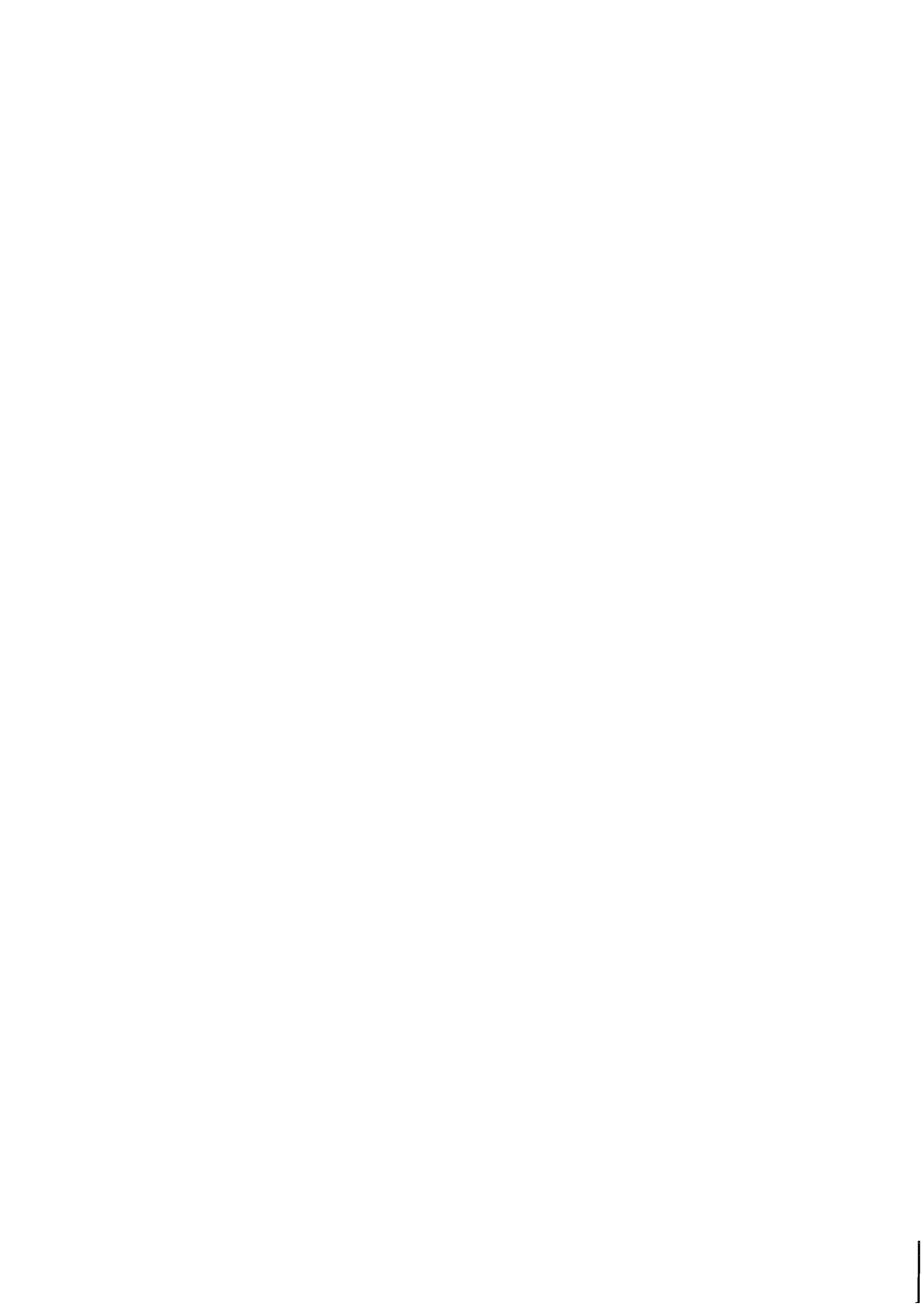
### **The 1–3 March ERI Meeting**

The present volume contains major contributions by Soviet scientists, together with comments by western experts offered during the 1–3 March 1990 ERI Meeting. We believe that this material is of wide and timely interest and may also serve as a reference document for later studies once the time has come to penetrate scientifically the very fast changes we are witnessing today in central and eastern Europe.

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Leader

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# Introduction

The significance of changes, taking place in Eastern Europe, is difficult to overestimate. The year 1989, without changing any borders, practically recarved the political map of Europe.

Economic reform is among the most important aspects of transformation. Attempts to move away from the centrally planned economy model were undertaken several times during the last few decades. Yugoslavia after 1948 and Hungary after 1968; Soviet Union in 1965 and Czechoslovakia in 1967–1969; Poland in the beginning of seventies and again during the eighties have been making different (in deepness and success) efforts to transform individual features of the “command” model. However, never before has the scale and decisiveness of the reform been similar to its current endeavors.

This phenomenon cannot be explained by political reasons alone. The internal shortcomings of the “command” model (primarily, the absence of stimuli for intensive work and inefficient distribution of resources) clearly surfaced during the current stage of industrial revolution, at which time the complexity of national economic systems has increased tremendously. The administrative management, which was more or less successful during the period of industrialization, ceased to cope with the conditions when the pace of an economy’s adjustment to the changing environment acquired decisive significance.

As far as political factors were not the only source for change, they also cannot provide the irreversibility of transformation. The reform will “go through” only if results of the economic performance begin to be accepted by the majority of population.

Several reform attempts collapsed in last decades not only due to the resistance of vested interests, but also because their realization was accompanied by inflation, declining growth rates and growing income differentiation. The main cause of faults: inconsistency and contradictoriness of transformation.

Two ideas de facto dominated over the reform process: the idea of collective ownership and self-management and the idea of "normative" (economic) regulation. In the most pure form self-management was implemented in Yugoslavia, but its elements can be found in all East European countries, embarking on the path of reforms. Normative regulation, i.e., ensuring the given output not with the help of directive distribution of plan targets between enterprises, but on the base of manipulation with economic parameters (including their determination in individual bargaining between enterprise and state), in the most consistent form has been implementing in Hungary.

The practice confirmed internal fallaciousness of both schemes. Among the shortcomings of collective ownership and self-management are the following: insufficient disposition to savings; the low innovativeness; inefficient distribution of investment resources due to the lack of capital market; limited mobility of the labor force; special possibilities of political pressure of self-managing enterprises on local and central authorities.

The main problem with the normative regulation revolves around "soft budget constraints," which caused by financial paternalism inevitable at the conditions of dialogue "enterprise – the state" and their joint responsibility for supplying the market. The inflational potential of an economy managing with individualized financial levers is much more than the potential of the "command" model. The transition from administrative to normative control is especially dangerous under the conditions of extreme disequilibrium – it was clearly demonstrated by the development of the U.S.S.R. after 1985.

The giving up of centralized responsibility for the production of a selected variety of goods is necessary for stiffening budget constraints of enterprises, averting open or repressed inflation, lessening of shortages. Three main socio-economic functions have to remain in the hands of the state: the creation of conditions for efficient market functioning; the realization of social policy; the fulfillment of necessary measures, that are neglected in the pure market environment (support of fundamental sciences, capital investments into environment protection, etc.).

Since the beginning of 1990 Poland has been the first East European country, which began to shift toward a "real" market. No doubt, Czechoslovakia will follow its example soon. Most probably, all the others also will not wait for too long. However, there are various obstacles on the path from a command to a market economy.

Firstly, the creation of the competitive environment is necessary. Primarily it assumes demonopolization and privatization of the economy. The extreme level of monopolization in all East European countries not only

prevents the "liberation" of prices, but also encourages the concentration of vested interests opposing the reform and pressuring the government (to soften budget constraints, to provide preferential foreign trade regime, etc.). Among the goals of privatization are: the stimulation of more intensive labor efforts and improvement in the level of efficiency; an increase in innovativeness; the absorption of the "superfluous" labor force, released from the state sector; the hardening of budget constraints (state enterprises are not only accustomed to the permanent financial support, but have acquired special abilities to obtain it). The very important role privatization may play in the creation of the social base of the reform – owing to deetatization (privatization "from above") and to increasing number of small private firms (privatization "from below").

Secondly, modern market institutions (of both product and factor markets) are practically absent in East European countries. The two-level banking system has only been implemented in Hungary and Poland (although it does not work properly). The security market does not exist at all (as well as stockholding companies, investment funds, etc.). The modern insurance system is not known. Commodity exchange, marketing and auditing firms and the like are also absent. The management of public property in a market environment presents a special problem.

Thirdly, the labor (a specific factor) market is practically lacking. The impossibility of unemployment and centralized wage determination resulted in overstaffing in the majority of enterprises. Market regulation of labor relations calls for the implementation of labor exchange and retraining systems, introduction of unemployment benefits, etc. The serious obstacle for creation of a labor market is the lack of a housing market (which severely restricts options for migration). The implementation of the tripartite model of labor relations is also necessary. The new legislation on trade unions (which previously just served desires of the state) also has to be altered.

Fourthly, new forms of foreign economic relations management are needed. The state monopoly on foreign trade, existed in all CMEA-member countries, presupposed the existence of purely administrative export/import regulations, an artificial exchange rate, centralized distribution of hard currency. The transition toward mainly economic (primarily, tariff) export/import regulations, the creation of the preferential regime for foreign investments (not only in the form of joint ventures), the gradual implementation of convertible national currencies are necessary.

Fifthly, the inflationary situation existing in the majority of East European countries, calls for the realization of a special stabilization program.

Its main elements are: regulation and unification of the tax system; limitation of increase in personal incomes; sufficient growth in interest rates and the limitation of money supply; stimulation of savings by increasing interest on deposits; the rapid cut in budgetary spending and the discharge of the deficit by loans. The transitional character of the economic system and the extreme degree of disequilibrium have to be taken into account in preparing the stabilization program. The non-admission of a deep recession (which might depreciate results of the financial renewal) is a difficult and specific task.

Sixthly, market self-regulation presupposes a departure from the overwhelming state price control. However, just simple and immediate price "liberation" may result in unpredictable (including political) consequences. The decisive but gradual liberation of prices (as well as increase in centrally regulated prices) must take place under the careful state control. The price liberalization and simultaneous introduction of compensational mechanisms (for instance, indexation of wages) are among the most important elements of the stabilization program.

Seventhly, the transition to a self-regulating market calls for the realization of various social policy measures. Their goal is not only to support those social groups who underservedly lose their share of national wealth in the process of the reform, but also to maintain popular consent for changes. The question of the consent is especially important for the Soviet Union where the majority of the population is still not convinced of the advantages of a market economy and the populist ideas traditionally dominate over the aspiration for wealth.

Eastern European countries have practically no practice of market management. Experience and knowledge, necessary for the administrative control, can hardly be used for the regulation of the modern market. Therefore, application for the western help seems natural: institutions that are currently being established in Eastern Europe have been functioning for decades in the U.S.A., Western Europe and Japan.

However, while western countries have substantial experience in managing existing market economies, they are unfamiliar with the optimal transition path from the centrally planned to the market model. The problems of the transition, never so actual at the past, were not among the most popular problems of scientific studies. We are convinced that the most efficient way to solve the transition problems is to combine the knowledge of East European experts (on their economic systems) with the knowledge of their Western colleagues (on regularities of the modern market). This is IIASA's

premise in the organization of the research on the economic reform problems in Eastern Europe.

A simple methodological device was proposed for the joint research: East European experts had to prepare papers on their approaches in dealing with reform problems in relevant countries. The discussion on these papers, their expertise and comments from the Western side provided a basis for the search for new solutions, for the elaboration of concrete policy recommendations.

The collection in this volume reflects exactly this schedule of the conference held on March 1-3. The "basic" papers for the conference were mainly written by experts from the U.S.S.R. This certainly does not mean that the IIASA Economic Reform and Integration Project is more preoccupied with the Soviet issues than with the problems of other East European countries. The Soviet situation is simply the most intricate and it was easier to obtain the full picture of the existing complications by dealing at the first stage primarily with the Soviet reform plans. Later the role of "stimulator" will be played by the materials from Hungary, Poland, Czechoslovakia and Bulgaria. Experts from these countries participate actively in the ERI project.

The structure of the monograph corresponds quite closely with the above mentioned list of the "main" reform problems. However, certain differences also exist. These can be quite easily explained. The practically oriented discussion on the problems of transition calls for the combination of problems from different areas of the economic science in a single "block." Thus, problems of the capital market correspond naturally with the questions of privatization – deetatization cannot be separated from the introduction of securities and the creation of the relevant market. The deregulation of prices cannot be isolated from the demonopolization; questions of the social support must be linked with the stabilization program, and so on. The structure of the book corresponds with the agenda of the IIASA conference and reflects the logic of the elaboration of policy alternatives.

The book consists of five sections. The first is devoted to the general problems of the economic reform. Focal points of the reform, main obstacles impeding its realization in the U.S.S.R. are discussed in the paper of E. Yasin. The concrete (and rather detailed) reform plan can be found in the article of G. Yavlinsky. The main ideas of the plan correspond with the "Polish" variant and might be characterized as a "shocotherapy." Other schemes definitely can be proposed, but the analysis of the extreme variant allows to illuminate certain problems more strikingly. The comment to these paper is provided by M.J. Peck.

Two "basic" papers are also in the second section. The first, written by S. Aleksashenko and L. Grigoriev, discusses the entire spectrum of the questions of deetatization and the problems associated with the creation of a capital market. The second, proposed by A. Chubais and S. Vasiliev, deals solely with privatization as a mean for the restructuring of a "command" economy. The comments to this section are prepared by K. Uno.

The problems of unemployment and the labor market's formation in the U.S.S.R. are examined in the third section. Full employment is among the corner-stones of the "East European socialism." Therefore measures, discussed in the paper of V. Sherbakov and A. Shokhin influence not only the economic efficiency, but also the social equilibrium and may prove to be crucial for the success of the reform. The comment to this paper is written by A. Rees.

In the fourth section I. Ivanov expounds the Soviet approach to the reform in the area of foreign economic relations. In this case U. Kivikari has made the commentary.

The fifth and largest section is devoted to the macroeconomic policy issues. Papers of the Soviet experts located here deal only with some of stabilization mechanisms. However, exactly these mechanisms might become especially important in the process of the transition to the market. The first is the mechanism of fiscal and monetary policy. Its analysis (in the context of the U.S.S.R.) can be found in the paper of K. Kagalovsky and A. Khandruyev. The second mechanism is the tax system. Its new construction, under implementation now in the Soviet Union, is described in the article of P. Aven. The comment (not only to the stabilization program, but to the whole reform plan) is prepared by W. Nordhaus. Within the general reform context the stabilization problems are also treated in the paper of D. M. Nuti. Special attention is paid here to the comparative analysis of different reform schemes, chosen by East European countries.

At the end of each section there is a short resume of the conference's discussions. In fact, papers themselves had to provide a base for further debates. The quality of the discussions confirmed the validity of the proposed approach, and East European experts were not the only ones who gained.

For the decades Eastern and Western economic thinking were separated one from another. Different conceptual framework, different languages hindered the mutual penetration of productive ideas, the assimilation of fruitful experience in efficient management (which exists not only outside CMEA). We are sure that the investigation of the East European reform options might be helpful not only for these countries. At present, centrally planned



economies boast of a population more than 1.7 billion. The inadequate comprehension of the economic environment of these states is a serious gap in Western economic science. The filling of this gap can give a strong impetus to the development of economic theory.

The joint discussion on the problems of the transition to a market economy may also prove to be useful to the West in a practical sense. Firstly, the participation in such a discussion not only allows to monitor changes, but also permits to influence and coordinate decisions made in the East with the situation in the West. This mainly concerns international economic relations.

Secondly, such problems of the transition as debureaucratization and decentralization of management are of universal significance. Therefore, Eastern Europe may, to some degree, turn out to be "proving grounds" for identifying feasible solutions.

Finally, the participation of Western economists in resolving East European problems is justified by the fact, that results of the economic reforms in this part of the World will decisively influence the development of mankind. A possible fault of the transition to the market will influence the political climate, all aspects of the East–West relations in an unpredictable manner. As a result all countries now appear to be interested in supporting the successful development of the others to attain mutual security and well-being.

*Peter O. Aven*  
*Stanislav S. Shatalin*  
*Friedrich Schmidt-Bleek*



**Part I**

**General Problems of  
Economic Reform**



# Modern Market Institutions and Problems of the Economic Reform in the USSR

*E. Yasin*

The essence of the radical economic reform in the USSR is the transition from the administer-and-command system to market economy. This is a difficult process because each of the two economic systems forms a whole, is internally coherent and, as a result, incompatible with the other. Therefore, speaking in general, without going into particulars, it is impossible to borrow elements of the old system to develop a new one or, conversely, to get a new system by replacing some structures in the old one.

Continuity is always desirable. We should never destroy what exists if we can find some use for it. Continuity in culture, traditions, national and personal values is particularly important. This is especially true for our country where the revolution, based on different assumptions, has caused much destruction.

In this case, however, a drastic and rather painful policy is inevitable which will probably extend over a number of decades in the USSR history. Whether such radical restructuring is necessary is not a question about choosing a strategy for the transition, but whether Russia needs to make the transition to market economy. Debate on this subject is still continuing in the country and it would be strange if it were otherwise. However, for me and the majority of experts the answer is a foregone conclusion. Major radical changes in the USSR are necessary both in terms of the

technological structure of production and in the economic and social relations. The rationale for this is provided in what follows.

It should perhaps be pointed out that Russia has never known highly developed market relations. They began to emerge after the abolition of serfdom in 1861 and made difficult progress, hampered by vestiges of feudalism. There was also considerable traditional interference in the economy by the state.

As a result, social institutions and value attitudes that are necessary for the normal functioning of a market, were few and unstable. The overwhelming majority of the population in Russia and outlying provinces practiced subsistence economy and communal relations.

The revolution destroyed even those market structures that had formed by the time it began. They were not fully restored during the NEP. As is known, they were not developed further and were replaced by the administer-and-command economy.

When this economic system exhausted its potential and its evolution brought the Soviet economy to a crisis, once again it was argued that the only credible alternative for taking the country out of decline and ensuring its normal development in the family of civilized nations was a modern market in the USSR.

If the market mechanism is to function effectively, it is necessary to have certain conditions and institutions relating to the sphere of economic relations, technological structures of production as well as social and political structures.

In all these respects the structures of Soviet economy are not only different from those that are necessary for the functioning of the market but, in a sense, are opposed to them.

Let us begin with the economic relations.

1. A necessary institution of the market economy is full *self-reliance and independence* of agents operating on the market combined with their *economic responsibility*. The latter manifests itself in strict budget constraints. Only when this condition is met, the subjects of economic activity will be motivated to behave in a manner that will ensure the effectiveness of the market mechanism. In capitalist economy these conditions are created by private property legislation, even though in real economic relations, given the nature of modern production and for a number of other reasons, distributed forms of property prevail that can be interpreted as collective or public property. Nevertheless the independence and responsibility of market agents must exist.

In Soviet economy a basically different type of relation has predominated to this day. The overwhelming majority of enterprises are owned by the state. They are subordinated in administrative terms to ministries and other state bodies, and must carry out their orders. In theory they enjoy economic self-reliance and responsibility, and in recent years their independence has been enhanced. In practice, though, they are dependent on the state because they must fulfil state orders and can obtain material resources primarily through channels of centralized distribution. What is especially important is that in reality they are not allowed to go bankrupt and their budget constraints are not stringent.

In order to create the conditions for market regulation steps have been determined to de-etatize the economy through promoting cooperatives, small private business and transforming state-owned enterprises into share-holding companies, joint stock companies, and leasing them, which, in fact, amounts to contractual relations between enterprises and state bodies.

2. Market economy is *contract economy*, an economy of deals between equal partners, a developed system of horizontal ties, relying on a market infrastructure – wholesale enterprises, stock exchanges, banks, insurance companies, other financial institutions, developed legislation, regulating relations among the subjects in the market, etc.

In principle, almost all these elements exist in the USSR but, one could say, in a degenerate form, sapped of vitality and real content. In particular, relations among partners are usually formalized in contracts but so far they are of secondary importance. To a considerable degree their content is determined by state orders, limits on material resources, the linkage established by the state bodies between consumers and suppliers, and centrally controlled prices. Therefore, not horizontal but vertical ties predominate, that follow the lines of the administrative hierarchy. Under these circumstances, an order usually overrides contractual obligations and legislative norms. This is not to say that orders are always carried out. However, even outside the framework of formal relations, because of the predominance of orders, the responsibility of partners and legal discipline becomes weakened.

The market infrastructure is also poorly developed and the self-regulating market exchange institutions are either totally absent or almost non-existent. The standard system of communication and information operates from “top to bottom”. If most enterprises today are allowed immediate access to the market, many of them will be at a loss not knowing who they should best sell to, buy from, at what prices and on what conditions, or what to do in

case of failure. Of course, they won't gain the necessary experience without taking the first step but during the initial period problems are unavoidable.

That is why a program is needed to develop the market infrastructure and to strengthen contractual and legal relations.

3. Free prices are a necessary market institution. Although most countries regulate prices, free pricing in a market economy is a common truth. Without that, it is impossible to balance the economy, to use the resources effectively and to create a consumer-oriented demand.

In the USSR a centrally controlled price system based on cost has evolved over decades. It is characterized by profound deformations and discrepancies with world market prices. As a result of all this, enterprises have become disoriented; they often use the independence, which they have been granted to the detriment of society because their interests and the interests of consumers diverge and sometimes can be reconciled only through administrative interference. There is no price on land and other natural resources with resulting distorted costs and resources-intensive economy, characterized by poor management of primary resources.

Another important special feature of the Soviet pricing system relates to disproportions in the correlations of retail prices – free housing, huge food subsidies – and, at the same time, high turnover taxes on other consumer goods. This has resulted in serious and enduring imbalances in the structure of the consumer demand and has shaped consumers' specific preferences. To correct these imbalances a one-time price review is envisaged and on this new basis the gradual transition to free pricing will begin. However, this will be a rather difficult and painful process because it entails destroying the existing preferences, consumer stereotypes and the structure of production costs.

Generally speaking, it should be said that in all spheres the Soviet consumer has grown accustomed to shortages, that he must chase goods regardless of their price. Low prices guaranteed by the state are taken for granted. Price rises, inevitable during the transition to the market, are perceived by everyone as a violation of assumed obligations.

The transition to free prices in the USSR will also involve difficulties resulting from the structure of production in the Soviet economy, its divorce from the structure of effective demand and the bigger fraction of production of primary resources and smaller fraction of production of consumer goods. For that reason as well as a result of the high degree of monopolization to abandon price regulation will entail a high rate of inflation for a long time



until the structure of production is brought in line with the structure of demand.

4. The effectiveness of market place is contingent on the degree of competition and the environment conducive to competition. Competition requires a combination of economic, technological and social aspects. In particular, there should be a sufficient number of sellers and buyers in the market place for every product. According to Western estimates the number of producers must not be less than 8-15. The market is regarded as monopolized if four larger firms control over 80 percent of sales. Free access to the market by any producer is another important factor to consider.

In the USSR a policy of concentration and narrow article specialization of production has been in effect for over 70 years in the key industries. As a result over 1500 groups of articles are manufactured by one sole producer. 95-98 percent of most ball-bearings are produced by one single firm. The same is true of engineering, chemical and some other industries.

In some sense Soviet industry resembles a machine which is a combination of unique aggregates and all duplication has been eliminated in order to generate maximum effect from savings on the scale of production. Another analogy is also possible, a well organized administrative system involving a very clear-cut division of functions among department. No variety whatsoever! Within such a system competition is simply inconceivable for technological reasons.

Getting out of such a situation is very difficult because it would involve a radical restructuring of the entire production potential. To adopt devolution and breaking up of existing enterprises will inevitably and sharply increase expenses as a result of de-specialization.

The situation is mitigated by the following.

For one thing, in agriculture, construction, in food and light industries concentration of production is considerably lower, specialization is not rigidly determined by technological reasons. What is only required is to remove institutional monopolies in the form of administrative bodies which manage enterprises and open up regional markets which today are assigned to particular producers.

Secondly, the fact that all enterprises have all kinds of subsidiary workshops intended to meet their own needs and reduce dependence on unreliable suppliers can be used as a basis for production diversification and for gaining access to the markets of other articles. Small enterprises also have an important role to play in that respect.

However, the main avenue to overcome monopolism in the Soviet economy and to create an environment conducive to competition is to step up external economic exchanges. This process is impeded by the closed nature of the Soviet economy because the rouble is not convertible and there are few goods to export.

In order to overcome monopolism and create an environment conducive to competition an anti-monopolistic program as well as the program to stimulate small business are being developed in the USSR.

5. A stable financial and monetary system is a requirement for the normal operation of market mechanisms. In principle market is enough to balance goods and money within an economy. But this is achieved above all through free pricing. Only when an economic system has inbuilt effective instruments to limit government expenditure and money supply will free pricing not lead to inadmissible rates of inflation.

As a result of its imminent laws the administer-and-command system inevitably generates a commodity-money imbalance and shortages. Management is effected mainly on the strength of in-kind indicators, therefore financing of measures included in a plan was always regarded as a secondary task to be taken care of by financial authorities and the State Bank. As a rule they could offer nothing but excessive emission.

In the years of perestroika this financial carelessness played a cruel joke on us. The anti-alcoholism drive, shrinking consumer imports as a result of the falling world oil prices and finally the loss of control over the money incomes of the population in the initial stages of the reform have led to a huge deficit in the state budget and a gap between the incomes and the expenses of the population of at least 30 percent. At the same time public pressures have prevented a hike in prices which could bridge that gap.

A program of financial recovery is being implemented now. It calls for a considerable reduction in government spending including investment and defense expenditure, financing of the budget deficit by issuing securities and raising interest rates. A tax is introduced on increases in remuneration funds. Neither retail prices nor social programs have been affected so far.

Efforts to achieve financial recovery and strengthen monetary circulation will have to be taken, however painful they may prove. Otherwise, the economy will slide into increasingly natural economic relations, erosion of growth incentives and an aggravating recession – and these phenomena can be already observed today.

A banking system capable of regulating money supply will be an important element in achieving financial recovery. The present system based

on centralized distribution of credits and administrative control over the activities of loan recipients is ineffective because it can be bent by state and party authorities. At present the government is considering bills on which to create a contemporary two-tier banking system and channel the operations of the State Bank of the USSR towards managing credits and money supply by applying economic levers.

The problem is, however, whether the banking reform should precede or follow other measures. This question is broached because there is a risk that the banking reform will loosen, if only for some time, control over money supply in the absence of free prices which would subsequently restore the "goods-money-prices" balance.

6. A market mechanism is only efficient if the economy operates on market principles. In the conditions of the Soviet Union that means creating financial and labor markets along with commodity markets.

While there are already embryo commodity markets in the Soviet Union the financial market and its associated institutions do not exist as such. No experience in that sphere is available either.

Within the command economy the appropriate functions were vested mainly in centralized capital investment planning.

The decentralization of investments right away focused on how to distribute and use them effectively. Besides, the need for financial recovery has forced us to look for ways to tighten money supply. Such are some internal incentives for the formation of the financial market. Obviously it will be initiated by the sales of government securities. Later, as the economy is de-etatized, industrial securities will also appear on the market.

The labor market has always existed in the USSR. The attempts to squeeze it out through a state labor remuneration system only bastardized it and stepped up inflationary pressures. The impact of supply and demand on the level of remuneration was effected through the need to raise wages for workers of scarce occupations irrespective of their skills and other qualities. At the same time there is no market regulation machinery which exists everywhere. There are no collective bargaining agreements between trade unions and employers because almost the sole employer is the state which controls trade unions as well. More often than not the management cannot represent the employer's interests because it is not interested in saving on wages or salaries. On the contrary, the management tends to settle all labor conflicts by granting raises. What is needed therefore is external checks similar to plan indicators, limits or, as is the case lately, tax regulations. This is what explained the loss of control over the growth of incomes which occurred in

1988 when administrative methods of planning remuneration expenses were abandoned.

Collective bargaining agreements do exist. Their role has been increasing in the last few years, particularly as the trade unions have changed their attitudes and an independent labor movement appeared like workers' committees (strike committees in Kuzbass, Donbass, Vorkuta). These agreements, however, contain no provisions about pay.

One distinguishing feature of the Soviet labor market is the low mobility of the work force, particularly in Central Asia and the Caucasus, which is largely due to the specific situation in the regions. However, there are other factors as well that heavily restrict labor mobility. Those are scarce housing and a residence permit requirement. Those restrictions cannot be easily removed.

The labor market in its normal forms requires an effective system of job placement and introduction of unemployment benefits that would protect the working people from the vicissitudes of the market and would relieve enterprises of the need to deal with relevant social tasks. In the Soviet Union those institutions too are in a latent state. The system of job placement is there but it is ineffective and needs a radical restructuring. There are no unemployment benefits and their introduction in conditions of a huge budget deficit is likely to be too much of a burden on the budget. Even today unemployment exists in the Caucasus, Central Asia and some other regions. The introduction of unemployment benefits would immediately require major allocations to pay benefits to those who are already unemployed at this time.

Finally, it is enterprises that currently have to deal with major social tasks, including the task of maintaining manpower reserves. Bringing about changes in the existing situation would involve significant social problems.

We plan to support the establishment of financial and labor markets with corresponding legislation, a revision of the system of wages and salaries and a program of social support for the population. The latter envisages examination of the employment problem, unemployment benefits and the system of population income indexation which is mainly aimed at alleviating the adaptation of the population, and in the first place people with low incomes, to market economy conditions, and setting the stage for introduction of free prices.

7. *The development of foreign economic relations*, making the Soviet market open and closely linked to the world market is of great importance for shaping a market economy in the Soviet Union. It would be appropriate

to single out those of the known reasons that would make highly difficult, if at all possible, the development of market relations in our country if it were cut off from the rest of the world.

First, transition to a new economic system would inevitably involve difficulties, and probably a decline in production, whereas it is particularly necessary to support the consumer market and relieve social tension. An invaluable off-setting factor in this respect could be consumer goods imports and direct assistance by industrialized countries – particularly at the time when free prices are introduced. People could live with higher prices provided they see goods in stores the next day.

Second, when production is highly monopolized only foreign economic relations may help avoid major damage from deconcentration and on the other hand establish the conditions for competition on the internal market. Moreover, the country would badly need foreign investments in order to achieve a structural readjustment of the economy, production increments and introduction of advanced technologies.

Third, drawing on the West's experience in market relations regulation could be vital for us. In essence the question is whether we shall have to go through all the stages of shaping a market by ourselves, learning from our own mistakes and paying a high price for that, or we shall be able to assimilate what others have known for years.

In our country the opponents of market economy frequently argue that advocates of reforms suggest that Russia return to the 19th and even 18th century and live through the stage of an original capitalist accumulation with all the accompanying social stigmas. They assert that in its initial stages our market will be so uncivilized as to raise doubt whether it is worthwhile to submit the society to all those trials. Regrettably, there is some truth to that assertion.

However, such developments could be avoided above all by relying on world experience and giving priority in the development of market relations to the sectors of economy that may best assimilate that experience.

On the other hand there are major obstacles in the way of invigorating foreign economic relations such as, in the first place, narrow export base, disastrous balance of payments and non-convertible rouble.

The efforts taken to cope with the above problems are apparently insufficient particularly as regards boosting the exports and stabilizing foreign debt. We are working on a long-term program of making the rouble convertible, which aims first of all at making the rouble convertible on the domestic market. The least requirement for that is finding a solution to the problem

of pricing and sound finances, and forming a currency market for agents operating on the domestic market.

8. Particular mention should be made of *social and political problems* involved in shaping a market economy.

Market is a social institution that requires certain rules of conduct from people. An "economic man" with his inherent rational conduct, strongly motivated by considerations of personal profit, calculating, driven by the spirit of enterprise, ready to take risks and assume personal responsibility for his actions should be given public recognition. Equally society should recognize significant differences in the standards of living.

The model that is currently prevalent in the Soviet Union is that of an "administrative man", to use G. Simon's term – though in somewhat different sense. He is typically used to submission and giving orders, to living in a structure of prevailing vertical links.

In his subordinate role he is likely to show pro forma obedience, he is used to violations of his civil rights but on the other hand he is prone to sneak out of control turning to actions without rules. In a supervisor role he would consider it normal to use his authority and position – and not only in the interests of performing his duty.

Lower strata of the hierarchy expect the upper strata to protect them in most relations with the outside world while recognizing social paternalism as a norm. Entrepreneurial attitudes are far from being generally accepted and, if and when pursued, frequently manifest themselves in distorted forms. Egalitarian attitudes are widespread. Popular mind views social justice primarily as equal consumption rather than equal opportunities.

To complicate the matter a significant portion of the population live on the brink of poverty making egalitarian distribution at times vital whereas it is all but impossible to differentiate actual incomes and accumulate without prejudice to the minimal standard of living.

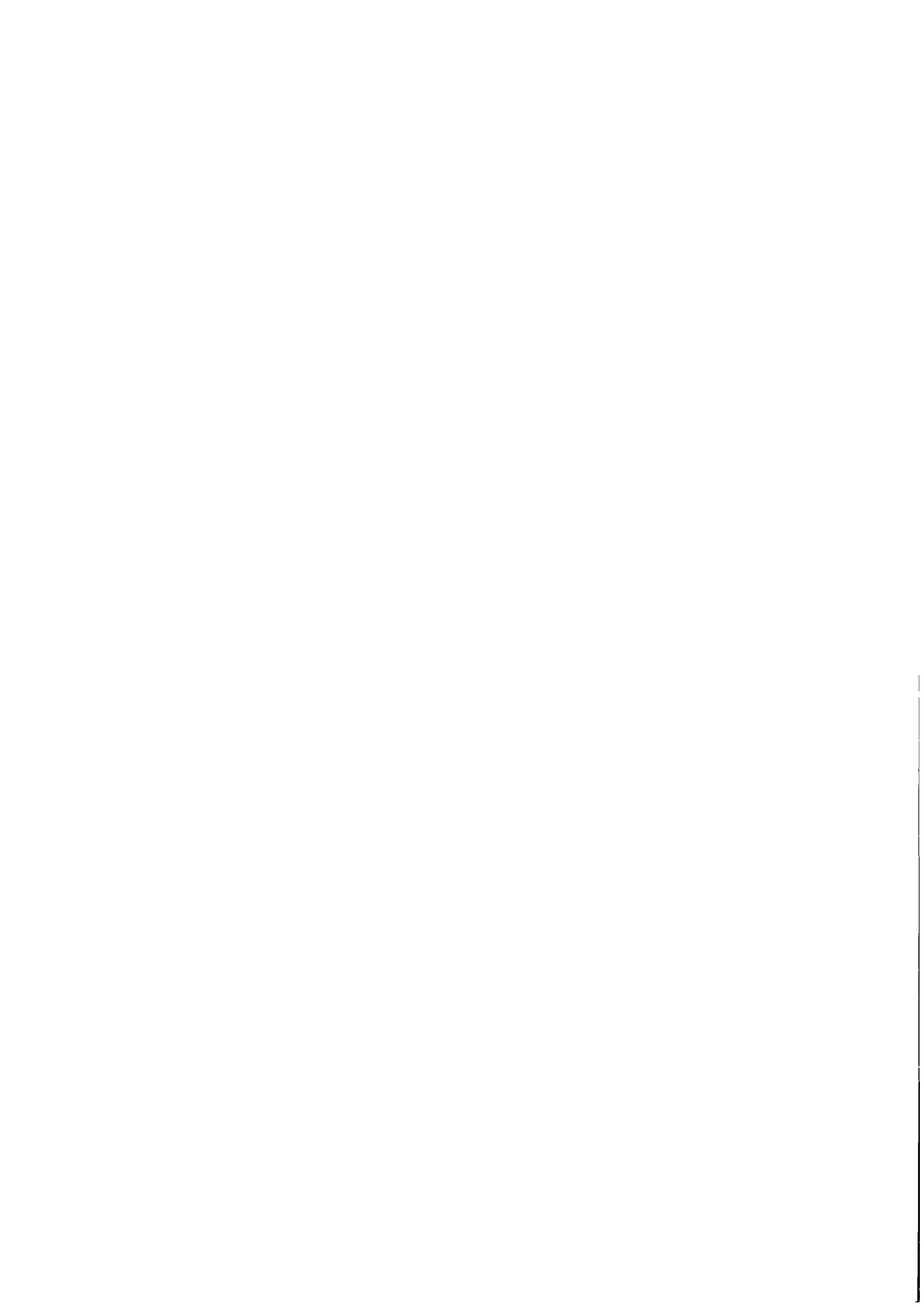
Precisely those factors determine the negative attitude of vast strata of the population toward the first results of the incipient market relations and in particular toward cooperatives and private entrepreneurs.

For the above reasons, shaping of a market and dismantling the administer-and-command system will inevitably tend to aggravate political problems and make a no small portion of the people espouse conservative political views and programs. It would be justified to say that consensus on a national scale regarding reforms, consolidation of the majority of people in defending the *perestroika*, confidence in the government and ability of the latter to continue to inspire that confidence through flexible policies on the

basis of a long-term program, those factors constitute a political prerequisite for the projected changes in conditions of democratization and *glasnost*.

All the above leads us to the conclusion that the process of shaping a market and its inherent institutions in the Soviet Union will involve great problems. The leaders of the country and Soviet scientists and specialists are aware of that. Measures are being taken to have those problems consistently dealt with. To that end a legal foundation is being established for market economy and a series of programs are being drawn up which taken together should bring about a transition to market economy. As it was pointed out, such programs include those for sound finances, de-etatization of the economy, social support of the population, antimonopoly measures and development of small business. An integrated government program of shaping a market is being currently worked out.

A key question is whether we shall have the time needed for dealing with all of the above problems in a consistent and integrated manner. A worsening economic situation and growing social tensions combined with destabilization of the political system may necessitate the use of emergency measures, in particular those that may be very painful. There are still many shortcomings in our work. However, we are confident that we have chosen the right direction and are prepared to pursue our goal with the determination and perseverance required by the situation.





# Program of Economic Reform: Popular Support, Stabilization, Restructuring

*G.A. Yavlinsky*

I would like to offer for your consideration a hypothetical model of an overall economic restructuring. Conditions required to realize the economic program option outlined below include the achievement of the legitimacy of authorities sufficient for the conduct of deideologized reforms, achievement of some kind of agreement between major social and political forces, the restoration of confidence in the leadership and, consequently, a renewed time credit for economic transformations.

The hypothetical economic program is predicated on the assumption that the goal to be sought in the reform period is not the creation of a new and effective system as a whole, but rather the codification of the genotype of a new economic system and the introduction of conditions conducive to its rapid self-development.

It is also to be borne in mind that substantial positive results should be achieved as early as possible in terms of meeting the vital needs of the population. This involves a clearly demonstrated trend toward “day-to-day improvement of many little things” with kind of a cumulative effect.

Furthermore it is, of course, important to determine what prospects are held out by the proposed system restructuring as a strategic course.

These are questions that call for an analysis and answer.

The situation prevailing in the country and marked by the existence of substantial excessive demand and the absence of full-fledged agents of market relations makes it necessary to stipulate a dual goal in the

first-phase program – the restoration of a balance and the creation of a system involving freely functioning economic entities. In the most general terms, this may take the form of handing over to the state the accumulated funds by juridical and physical persons in exchange for state property.

Concurrently, from the very first day, a set of declaratory and symbolic measures are to be taken to win the confidence of entrepreneurs so that further steps taken by the state to regulate economic activities cause no panic.

The de-etatization begins in the least concentrated and monopolized sectors of the economy that are directly related to the services industry and the production of consumer goods. Other sectors may be involved in this process primarily through the issuance of shares and through the turning of major enterprises within those sectors into joint stock companies not owned by the state.

The creation of the enterprise system is accompanied by drastic changes in the macroeconomic policy designed to stimulate the process of de-etatization, speed up to the maximum extent possible the restructuring of economy, to create, re-orientate, strengthen and substantially develop the system of minimum social guarantees to the population.

It is envisaged that the program will be implemented drawing above all on domestic forces and internal resources. At the same time a very useful assistance could be rendered by international organizations and individual countries – both material (such as the creation of stabilizing currency funds) and intellectual (such as consultations on the legal regulation of the new system; the organization of statistics, the establishment of stock markets and other market infrastructures, the organization of a banking system, etc.).

## **Transformation of Property Relations and Creation of a Free Enterprise System**

### **Legal Guarantees**

Ownership rights of Soviet and foreign juridical and physical persons with respect to any type of property, except for the property exclusively owned by the state, are guaranteed by law.

Soviet and foreign juridical and physical persons have equal rights to any kind of economic activities, except those prohibited by law, and are materially liable in full measure of the value of their property.

All articles are removed from the penal code and administrative legislation that relate to economic crimes (speculation, commercial mediation, private enterprise, etc.), and those convicted under those articles are pardoned.

State arbitration organs are transformed into a system of independent economic courts subordinated to the Supreme Soviet of the USSR.

Differences in the maintenance regime of bank accounts in Soviet currency for juridical and physical persons are eliminated. Those persons are granted equal rights to maintain currency accounts in any banks in the USSR prepared for that function.

### **De-etatization**

Subject to de-etatization as a matter of priority are enterprises of:

- retail and small-scale wholesale trade;
- communal services and utilities and, partly, other paid-for services (hotels, tourism, etc.);
- public catering system;
- construction organizations working on contract basis;
- state-owned farms and subsidiary farms of state enterprises operating at a loss;
- food and light industries;
- construction materials and wood-working industries;
- other industries with up to 300 employees.

The value of fixed and working capital assets of the said enterprises subject to sale will total roughly 350–400 billion rubles.

Furthermore, as a result of a housing reform, 10 to 20 percent of state-owned housing could be sold at the initial stage (estimated at 50 to 100 billion rubles). A portion of state-owned incompletely constructed facilities and uninstalled equipment with a total value of 20 to 30 billion rubles will also be subject to sale.

Thus, at the initial stage, the state will be able to offer property with a total value of about 500 billion rubles.

The amount of surplus money is estimated at 400 to 500 billion rubles (including 300 to 400 billion rubles possessed by citizens, out of which only 150 to 200 billion rubles are kept in savings banks, and about 100 billion rubles owned by enterprises).

There is a rough equilibrium between the demand for and supply of state-owned property. Such property may be sold for existing prices and for balance-sheet prices (possibly deducting wear-and-tear costs).

The main thing, particularly at the initial stage, is to prevent the pressure of the existing surplus money in the market from provoking a growth of prices and to channel the money toward the purchase of state property.

The order of the day is expeditious creation of diversified channels for de-etatization through individual sales, auctions, installment-plan sales, massive leasing of property with subsequent sales thereof, sales of shares, etc.

Making the new economic sector an lucrative field of business activity, coupled with a firm government policy of discontinuing all forms of assistance or support to inefficient and cost-ineffective enterprises and agencies.

Creation of a most favorable operating environment for small and very small business ventures. Favorable investment opportunities for funds kept in personal bank accounts.

Since the reform of ownership is undertaken on behalf of the owner, i.e., the state, the latter is in a position to take certain compulsory measures as well, such as introducing mandatory short-term high-rate leasing.

A PR campaign in the mass media with a broad discussion of a possible monetary reform (which, however, is not regarded as a necessity at this stage).

Furthermore, major industrial enterprises, construction and transportation firms receive the right to sell their stock on the following terms:

- shares can be sold to physical as well as juridical persons;
- most of the revenue (80 to 90 percent) derived from the selling of shares goes to the state budget, and the remainder is left to the enterprises for covering the costs of beneficial treatment reserved for shareholders;
- a regulation securing a 51 percent interest for the state is introduced with regard to certain enterprises;
- government-owned stock property is managed through a State Stock Fund (regional? commercial? independent from the government?) or a network of holding banks (state-owned?).

Free price formation is allowed in the de-etatized sector. In the public sector, price controls will be lifted after the privatization process has gained enough strength, i.e., in about six months. A one-time revision of prices in the public sector and manipulation of state order price rates are also possible.

Government measures in the area of price formation include:

- bringing down the prices of particular goods by means of government import policy and flexible use of state reserves;
- a requirement for notification to (authorization by?) state bodies in cases of price increases by enterprises occupying monopoly positions on the market, etc.

The macroeconomic policies of the transition period must lead to a balanced economy through reductions in government spending, inflation control and a restructuring of the financial and monetary systems. The objectives in the first phase are to make the ruble as strong as possible and to encourage de-etatization by every means available.

## **Budget Policy and Anti-inflationary Measures**

The current state budget must be balanced, which will require cuts to be made in the following items:

- subsidies to enterprises operating at a loss (10 billion);
- subsidies to the agricultural sector (30 billion);
- centralized investments (20 billion);
- operational spending (land improvement, mineral research prospecting, etc. – 5 billion);
- defense, with an across-the-board revision of defense spending.

Parallel to this, the centralized funds accumulated by ministries should be transferred to the state budget, and a tax reform should be implemented along the following lines:

- a single taxation rate for profits derived by juridical persons (using a progressive scale or other forms of withholding supernormal monopoly profits);
- progressive income taxation of physical persons on a more restrictive scale compared to taxes levied on juridical persons, to encourage investment in production;
- taxation of individual property; raising land tax rates as well as legacy and gift taxes, while individually-owned production assets are taxed at lower rates;
- establishment of an internal revenue service and introduction of a system of tax declarations (on a quarterly basis?);

- severe sanctions against physical and juridical persons in cases of tax evasion (fines exceeding 3 to 5 times the amount of taxes due, and prison terms);
- to restore the balance in the investment sphere and dramatically change the structure of investments, a 20 to 30% tax, calculated on the basis of projected costs, is levied on new construction in the production sector (preferential treatment is possible for industries producing consumer goods);
- indirect taxes on consumer goods may be raised in order to return to the state budget the supernormal profits resulting from the price increases that will be required to balance supply and demand.

A budget deficit not exceeding 2 to 3% of the GNP can be offset *only* by issues and selling high-interest government bonds.

The income derived from the sales of stock and of government property must be accumulated within a special division of the state budget to be transferred to the State Bank in payment of the government's internal debt.

A stock market is formed. The state holds auction sales of hard currency, mainly for enterprises.

*The banking reform* is designed to set the stage for the development of financial and capital markets.

As a first step, the Supreme Soviet takes control over the State Bank and receives the right to impose legislative constraints on the growth of the amount of money in circulation. A two-tier bank system is established. At the same time, the USSR State Bank begins to function as a reserve bank with a high reserve rate (20–40%) in the initial 12 to 18 months.

As an urgent preliminary measure, a clean-up of accounts in specialized banks is undertaken and all bad debts are referred to the State Bank to be recovered or canceled in cases of liquidation or juridical persons.

The local outlets of the State Bank and the Savings Bank are taken over by other specialized banks, which together with commercial banks, constitute the second tier of the bank system.

A significant increase (up to 15-20%) of credit interest rates. A credit reform directed at drastically limiting credit expansion.

Juridical and physical persons are granted the right to open accounts in any bank (including hard currency accounts as the banks get ready to handle them).

Banks are granted the right to issue stock and are subject to the general taxation procedure applicable to juridical persons.

Funds should be accumulated in a growing number of bodies operating outside the bank structure, i.e., pension and insurance funds.

## Foreign Economic Policy

In order to estimate the state financial reserve, an immediate full revision of all financial deposits is carried out, and part of the short-term debit is paid back.

Negotiations start without delay on obtaining credits on beneficial terms, as well as stabilization credits, on the regime of payments and on subsidies and direct investments. Measures are worked out and implemented to ensure prompt repayment of debts to the USSR by foreign countries, partly in the form of consumer goods supplies.

Establishment of hard currency insurance funds. Devaluation of the ruble and transition to a single ruble exchange rate for trade as well as non-trade operations; a large-scale programme of hard currency auction sales.

*Abolition* of licensing (adoption of a list of non-exportable goods); introduction of new customs regulations and new rates of customs duties applying to both physical and juridical persons.

Massive training of Soviet students and scholars abroad; Western consultants are invited on contractual basis to assist the development of new forms of economic management.

## Agricultural Reforms

Parallel to the establishment of legislative guarantees of the equal status of all forms of land ownership, a number of other measures are carried out:

- (1) All forms of direct subsidies to producers are terminated and replaced by subsidies for particular products and the consumer end (to the extent necessary for the rationing system to function).
- (2) Centralized investment in agriculture is minimized.
- (3) Capital funds of bankrupt state-owned farms are leased to physical and legal persons while the property of collective farms is divided among the members of the farm.
- (4) The farmers have the right to leave the farm freely and take with them their individual plot of land and the proportionate part of the property.

A limited market of a land is created by way of passing the ownership of land to physical and legal persons. The question about the price of land (competitive sales? cadastre?). At the beginning the right is to be given to collective farmers and workers of state-owned farms, to family garden holders associations and their members to buy for a small price lots of land for individual use; allotment of unused land for sale. At the first stage, as an alternative, land may be leased for a long period of time (up to 50 years) with the right to inherit it and buy by installments.

At the same time land tax rates are raised; benefits are provided to migrants to the regions with the shortage of manpower.

All restrictions on sale by individual or collective farms of their product are lifted, however, in case of rationing of basic food products, for certain types of products the state order remains 1–2 years. In such a situation it is possible either to limit the sphere of the state order only by highly efficient farms (with high sale prices) or to establish a universal level of “tax in kind” for all collective farms and state-owned farms (at lower sale prices).

The state control over prices is maintained only with respect to key types of agricultural products in volumes necessary for rationed distribution.

The centralized distribution of material and technical resource to agriculture is abandoned; they are sold through exchanges (fairs) and the network of dealers.

The union republics are given the right to choose specific variants of an agrarian reform.

## Social Guarantees

The main thrust of activities is to narrow the spheres of social guarantees for the active able part of the population and reduce the volume of redistributed net income through the state budget. The goal is to stimulate work and entrepreneurship.

The state refuses to guarantee employment at a *particular* enterprise, a Provisional Act of Bankruptcy is adopted and inefficient enterprises are closed down. Labor legislation is changed correspondingly.

In order to stabilize the situation with respect to the standards of life, to ease social tensions, with due respect for psychological climate and existing traditions, a special system of social protection is introduced.

- (1) Together with the introduction of de-etatization and free pricing, a system of rationed distribution is organized for basic food and industrial



products included in the minimum consumer budget (MCB). The minimum consumer budget is officially adopted by the Supreme Soviet of the USSR in physical (by elements) and monetary form. The level and the volume of distribution corresponding to the subsistence level constitute the basis for the estimation of the state order and the necessary production resources against the model of intersectoral balance.

At the first stage the minimum consumer budget becomes an instrument in setting minimum wages, pensions and disability (unemployment - ?) benefits.

(2) After the transition to free prices the *indexation of incomes* is introduced. At the same time:

- the maximum compensation for the growth of prices (up to 0.7–0.8 percent for 1 percent of inflation) covers only social benefits and pensions which correspond to the minimum subsistence level (there also can be linkage to average wages);
- the volume wage index at state-owned enterprises should not exceed 0.3-0.5 percent for 1 percent of the rate of growth of prices (for budget sectors, perhaps – 0.5–0.6).

(3) A *state unemployment assistance fund* is established through taxes on wages fund (profits ?) at state-owned enterprises, and through fees on entrepreneurs' income:

- unemployment benefits are introduced;
- labor exchanges are established and the allocations for re-training of personnel are sharply increased;
- a system of social work for the unemployed is established (communal work; road construction, etc.).

(4) Programmes of assistance to specific social groups are implemented:

- single old and handicapped people;
- homes for aged people and orphanages, etc.;
- subsidies to refugees and migrants;
- free meals, help to homeless people;
- nourishing diets and baby food.

To implement those programmes there is need to review and partially nationalize the property of major social organizations.

As was already pointed out, the main requirement that the programme should meet is that it should be very specific in terms of time.

Dates set for the implementation of programmes should allow for serious reforms, however, they should also meet with understanding and trust of the people.

## **The Beginning**

Administrative introduction of the systems of social protection. Announcement of the Programme. The beginning of voluntary de-etatization. Adequate, more rapid changes in organizational forms of the agrarian sector. Terms of obligatory leasing and de-etatization are made public, information is provided on the dates of termination of state subsidies, changing of terms of crediting, introduction of free pricing. Conclusion of the necessary international economic and financial agreements. Preparation and adoption of the first package of norm-setting and legislative acts.

## **The First Phase**

The new state budget is adopted. Subsidies and subventions in all types of budget financing are drastically reduced or discontinued. Inflationary fluctuations begin, prices grow and galloping inflation becomes a possibility.

The obligatory leasing is carried out. Sale of shares begins. Tax, bank and agrarian reforms are implemented. Sales of state property yields first 100 billion rubles, a part of this money is allocated to concrete social programmes. The de-etatized sector of consumer goods and services outgrows the state sector.

The process of stable growth of prices begins, the consumer goods price level becomes balanced and the structure of prices comes closer to the world one. There are no lines, the products become more expensive but accessible, and their consumption is reduced. There is a sharp deficit of money, both possessed by individuals and enterprises. Stronger work intensives appear.

People are rapidly released from their jobs, enterprises become bankrupt. The workforce market develops.

## **The Second Phase**

A structural change of the economy begins. The State Bank of the USSR pursues a rigid restricting policy. Inflation slows down. There is a possibility of a trend toward reduced prices for a number of consumer goods.

Entrepreneurship becomes widespread. Stabilizing programmes of the government begin to work: expansion in goods supply deflate prices, introduction of new target oriented subsidies eliminate disproportions.

The main set of measures envisaged by the Programme is completed: the genotype of a self-developing new economy is created.



# Comments on the Paper by G.A. Yavlinsky

*M.J. Peck*  
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Mr. Yavlinsky has provided us with a wide-ranging survey of many aspects of economic reform. I shall focus on only one of his points – the distinction between the small and large firm sectors – in the process of a shifting to a market system. The small firm sector includes the services, agriculture and small scale manufacturing.

Mr. Yavlinsky assigns priority to establishing a market system in the small enterprise sector. I agree with him because the problems of moving to a market system here are much less complex than those in sectors with large firms.

For small firms, economies of scale are limited, management and technology are simpler, profit incentives are easier to create for managers, workers and owners, and capital requirements are modest. These features all facilitate the establishment of competitive markets in the small enterprise sector. Furthermore, the Soviet Union already has cooperatives and individual ownership established in this sector and has legalized private ownership for most activities.

I would add three points to the discussion of the small firm sector:

- (1) In many services, courtesy and convenience are important attributes of quality. Competition in the services means pleasing the customer so that services can often improve without increased resources.
- (2) Labor-intensive services also can be expanded with little use of capital and materials. Greater and better provision of services is a way to give the Soviet consumer a way to spend his rubles.

- (3) Small-scale manufacturing enterprises can play a major role in the reform process. Notably, firms with less than 300 employees account for twenty-five percent of all manufacturing activity in the U.S. and fifty percent in Japan.

I agree with the American economist Ed Hewitt who says, "If national and local authorities encourage small business activity, the state of Economic activity could improve dramatically in a relatively short time with very little commitment of capital, labor, or material resources."

Let me now turn to the large enterprise sector. Fourteen hundred enterprises account for half of Soviet industrial output.

The large enterprise sector refers to the 1,400 manufacturing enterprises that account for about half of the industrial output and about one third of the industrial labor. Such a concentration, typical of all industrialized economies, reflects economies of scale. There is a conflict between achieving the lower cost of large-scale operations and increasing the number of competitors. Still, there are factors that moderate the sharpness of the conflict:

- (1) International trade permits concentrated industries to be subject to international competition. Relying on international competition, however, requires the full convertibility of the ruble, an unlikely prospect in the near future. Still, some of the scarce hard currency earnings of the USSR might be allocated to the limited import of high quality consumer and producer goods as a demonstration of the international quality standards that Soviet firms must eventually meet.
- (2) There may be more potential for effective competition among domestic enterprises than is generally recognized. Professor Yasin mentioned the need for eight to fifteen firms for effective competition. I would put the number significantly lower – five to seven firms and even three firms can provide considerable rivalry for market share. I do not know enough about the structure of Soviet industry to be able to say whether there will be many situations in which competition would be severely restricted by the scarcity of competitors. But the experience in the U.S. indicates that it is better to try to create conditions for competition than to rely on regulation as a means of protecting buyers.

The present industrial structure reflects a merger movement and the creation of production associations as part of the 73 reforms. Western observers have considered these peak units as proforma consolidations with little impact on the enterprises. If so, these units could be eliminated at little cost.

The production associations are clearer cases for elimination since these were established to assist in the planning process and to coordinate the activities of firms in the same industry. A competitive market requires that firms behave as rivals seeking sales from one another rather than coordinating their plans. Anti-trust laws in the United States and elsewhere prohibit agreements or even discussions among competitors on prices, market shares, or product quality – a necessary condition for competitive markets.

There are other problems facing reforms efforts in the large firm sectors apart from those in creating competition:

- (1) The isolation of the Soviet economy has denied it access to the recent developments in technology and management practice elsewhere. In this respect the USSR is in a similar position to that of Japan in 1945. The growth of the Japanese economy since 1945 shows that overcoming managerial and technological gaps can be the source of impressive economic performances if energetic measures are taken to import technology. Joint ventures with foreign firms represent a way of importing technology, management skills and capital. Soviet law provides for such ventures, but the actual progress has been slow. United Nations data shows that by the end of 1988, only 13 of 191 registered joint ventures were actually established and only 23 million dollars invested. Soviet authorities must recognize that attracting joint ventures depends on provision for managerial freedom, convertibility of profits, and higher expected returns – higher than can be obtained elsewhere. The establishment of the integrated market of the European Economic Community as well as the continued high level of economic activity in Europe, Asia, and the U.S. have given investors many alternatives to joint ventures in the Soviet Union.
- (2) Technological agreements in which the foreign firms offer only technological and management services but do not risk their capital are an alternative to joint ventures. Japan relied extensively on such agreements, signing 5,231 technology agreements from 1963 to 1970. As compared to joint ventures, such agreements are less costly in terms of foreign exchange since the purchase covers only services and information and not the capital contribution, but they require more sophistication on the part of the domestic purchasing firm for the domestic purchaser retains full control of the use of the technology.
- (3) Soviet enterprises are more highly vertically integrated than those of other industrialized countries, which is a consequence of input markets

characterized by frequent shortages. Large enterprises should devote efforts to creating a complex of small firms that would be their suppliers, by providing them financing, technical assistance, and long term purchasing contracts. These small firm suppliers should be encouraged to develop sales to other enterprises and eventually become independent of the large firms that started them.

- (4) Large enterprises should be encouraged to be self-financing for their investment needs by retaining their profits. In the reform discussions, much emphasis has been placed on creating capital markets equivalent to those in industrialized economies and yet external capital markets provide firms in other industrialized economies with a limited share of their investment needs. For example, 70 percent of investment funds for U.S. enterprises come from internal sources – retained earnings and depreciation.
- (5) Bankruptcy for large firms usually means their reorganization, rather than their dissolution. All parties – workers, creditors, and suppliers – must make concessions to bring the outlays of the firm to a level where they are consistent with its revenue. Judicial intervention is often required to force these concessions and often management is replaced. What should not be allowed is the provision of state subsidies to permit the large firm to continue to operate in the same way.

I regard ownership issues as less crucial for the large enterprise than for the small ones. There the employee, perhaps one individual among ten of thousands, will rightly consider his own efforts as having less impact on the success of the firm than in a work force of three hundred or less. Similarly, an outside shareholder, as one of thousands, has little control and influence over the decisions of a firm. I would think that a variety of ownership forms mentioned in the paper of our Soviet colleague are consistent with a market system.

Let me now turn to sequences of reforms. The small firm sector should have priority in the reform process. Establishing markets in the large firm sector may need to wait for greater macro-economic stability. But they are not completely independent events. Phasing out subsidies to enterprises, as a market system requires, will reduce the state deficit and so ease the macro-economic problem. The taxation of enterprises can also ease the deficit problem by raising revenues. I am skeptical about reliance on taxes based on the profits of enterprises. Determining profits is a complex task that is easily abused. Profit taxation requires the more profitable enterprises to carry a large part of the tax burden while the unprofitable ones come



off scot-free. It runs counter to the logic of a market system which requires rewarding profitable enterprises and penalizing unprofitable ones. It seems to me that a value-added tax is preferable. It is neutral with respect to vertical integration and would give the Soviet Union a tax system comparable to the European Economic Community, into which the Soviet Union may become more integrated.

I recognize that the Soviet Union has a tradition of egalitarianism, which is best served by inheritance and personal income taxes. The Soviet Union system already provides for a marginal tax rate of 65 percent on incomes of above 6,000 rubles, about three times the average wage.

Mr. Yavlinsky's paper provides an imaginative solution to the problem of the 400 billion ruble monetary overhang. He estimates the value of state property to be the same amount so that its sale would then soak up the entire monetary overhang, allowing the transition to a market system without the crippling effects of inflation.

Ingenious as it is, I doubt the feasibility of his solution. Property and securities are valued by future profits, which depend on a comprehensive information system that the Soviet Union lacks. Hence, it may be difficult to persuade individuals to buy securities at their accounting values.

Furthermore, much of the currency and bank deficits are held in expectation of the availability of more and better goods. To the extent that the reforms fulfill these expectations consumers will begin to convert their rubles to goods, thus driving up prices. Clearly, the monetary overhang is a major problem, but I doubt whether the sale of state assets can be more than a part of the solution.



# Summary of Discussions\*

*C.M. Schneider*

In general, before one indulges in analyzing the Soviet economy and making recommendations for economic reform, it should be completely clear that both a liberated or “free” market system and a centrally planned economic system have their own internal consistency. Therefore, it is not acceptable to simply suggest an interchange of a number of the undesirable elements for more desirable ones as a solution to the present crisis situation. The pieces in each system are interdependent. In the USSR, the critical elements necessary for the functioning of a market economy are missing. Reform politicians should not singly rely on “one-shot” adjustment measures or instruments. For example, radical decentralization of enterprises without free prices can easily lead to monopoly situations which will not result in the desired and required efficiency gains. If the inappropriate macro-environment is pervasive during the implementation of reform tools, one must expect negative effects such as wage and price inflation as well as shortages.

The accumulated problems associated with the functioning of a command economy model can only be solved by engaging in a transition to a market economy. Doubtlessly, this is more easily said than done. The transition from one non-contradictional, integrated system to another is a clear step toward finding a solution to these troubles. As stated, it is impracticable and counterproductive to merge the two systems. A decision must be made to either move to the new system completely or not. The fundamental problem in the Soviet Union, for example, lies in the absence of institutions characteristic of a market economy. Responsibility and independence of

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\*Comments made by Richard Cooper (USA), Ognyan Panov (BG), Leonid Grigoriev (USSR) and Karol Lutowski (PL), Alfred Kahn (USA), Pavel Klima (ČSFR) and Heinz-Dieter Hausteil (GDR).

economic actors are needed and should be more strongly encouraged. Horizontal integration and the links between economic sectors and agents are unknown elements of an institutional structure that has been wholly dominated by vertical connections which are dictated and not subject to laws of competition. Along these lines, the need arises for liberated prices that are not set by a central committee irrespective of real costs, output or demand, but give true signals of supply and demand conditions in the market place. Two of the main barriers to a price reform are the enterprises, which have become accustomed to obtaining inputs at unreal prices, and the working class, which panics at the thought of not being able to afford the basic needs if inflation should sky-rocket.

The move of an economy from a command to a market system will usually be accompanied by serious adjustments and modifications in the structure of production and the distribution apparatus. The Soviet Union is characterized by a dangerously high level of concentration or monopolization in all sectors. Simultaneous to the establishment of a more horizontally integrated production structure that can be directly encouraged through increased privatization, new and well-functioning internal and external links within and between sectors will be necessary to overcome the problem of inefficiency and shortage in a country rich in resources. Unfortunately, there is a lopsided concentration of investment and production effort in primary resources, which inevitably leads to a feeble consumer sector. At this time, the Soviet Union still has no real financial market, a centralized system of resource allocation presently substitutes for what should be a capital market and the labor market is characterized by an abundance of inadequacies and a lack of real structure. A goods market based on supply and demand conditions, as well as capital and labor markets supported by a solid financial system and incentives and motivation are all essential elements of a market system that could help a nation moving away from a command system toward growth and security.

In any case, policy-makers and economic advisors should be aware of the fact that every society has an established social contract on which the relationship between government and citizens is based. The relations and roles of commerce and industry to the aforementioned main parties are also inherent within the said agreement. The entire labor force relies to some extent on expectations of real wages and job security which in no small part influences the overall economic stability. In no instance can a government violate the social contract without peril. In the popular mind, social justice is equal to social consumption rather than to social opportunity. The consequences of

equal opportunity must be socially acceptable in order to introduce a market economy, otherwise social disruption will result, as becomes clear in Professor Yasin's statement, "A Soviet citizen would rather die of hunger than of envy." Of course, the fundamental advantage of a market economy is that it directly encourages the mobilization of each individual in society, as well as his talents, tastes and way of taking risks.

After realizing the great difficulties and costs involved in moving from an established centrally planned economic system to a market economy, the question of whether it is actually worthwhile to change completely from the previous system definitely becomes a valid one. What is certain, is that a comparative analysis of the expectations of an indicator, such as output per capita, under the old system on the one hand and under a free market system on the other hand must be made over a certain time profile. Even if only in a relative sense, this would at least allow the determination of which plan of attack would be more beneficial for the country in the future. The potential gains of a shift between systems and the characteristics of the probable adjustment path must be investigated before any decisions as whether to proceed or not are made.

The old, traditional eastern European systems as they are today, are clearly no longer consistent with the economic situation and progress of the industrialized world where the striving for productivity and efficiency increasingly dominates the scene. It would prove impossible to adjust to the Western information society based on technological progress within the framework of the centralized base in which the activity of individuals for the common good of the economy is not sufficiently encouraged. The human factor is an essential element when attempting to attain productivity increases. Unfortunately, the old monopolistic system does not really allow for the influence of the individual active human factor.

Using the real life example of Poland, some short-term effects of a radical economic reform can already be seen. In this case, the most unpleasant surprise was the incredibly high inflation. As a result of the shock, the standard of living and the levels of production and of real income fell significantly. The period of reduction was shorter than expected and it has reached a type of temporary equilibrium. Consumer goods do become available at the new higher price level, but only for those few who can afford the higher price. The liquidity of the banking system became questionable and many enterprises withdrew within themselves. Although it seems that in a number of instances the work ethics and moral have improved, enterprises continue to go bankrupt, each time posing a liability for the budget. Additional

unexpected and expected events continue to occur. Results such as these lead to the question of whether the reform program will be delayed, or not.

The task of overcoming the fundamental hurdles of economic reform pose a macro-cosmic problem to the Eastern European countries which neither they, nor especially the West, should underestimate. A free market is free of governmental controls, free of governmental regulations and incorporates a system of free pricing. The complexity involved in a move to free prices is enormous because the target is always changing due to the dynamics of the economy. The introduction of only partial freedoms cause several distortions to arise. This type of process often leads to the infamous "snowball-effect" which can instigate complete economic disaster. The key to success lies in swift movements, actions and policy implementations. Slow deregulation, for example, with prices based on average costs causes severe distortions. It is always crucial to recognize the differences arising between the relationships in demand and capacity due to the reliance on marginal cost calculations. Inevitably, prices and quality move to the forefront.

The path of deregulation which is decided upon, must be introduced into the appropriate environment and provide the direction for further liberalization and growth in the economy. Anti-trust laws are usually a standard requirement to protect competition, while the deregulation itself directly provides incentives for better performance. This economic maneuver should also encourage the move away from oversimplified cost/plus pricing systems. At the same time, various methods of dealing with the social costs of a transition to economic freedom will be essential. These may include direct contributions, transfer taxes (in the form of differential excise taxes – even negative excise taxes for food) and awareness not to double tax consumers. A fundamental requirement for a global open market is that individual free markets must be consistent and compatible with one another.

Competition will influence the behavior within the small and large firm sectors differently as a result of their structural and managerial dissimilarities. In the small firm sector, the characteristic problem of competition is usually simplified in comparison to the situation with the larger counterparts. Although the ownership side is quite clear (where the different forms also include employee ownership), the more important issue lies in directing or initiating the required capital investment flows to the managers. The bottom line in the small firm sector is the closer ties to the consumer which encourage the desire to please the customer. The introduction of more active competition in this area can raise the quality of products and service without actually raising (sometimes even reducing as a result of

rationalization) the utilization of real resources. This trend is frequently linked to specialization which leads to sub-contracting due to the comparative advantages between the enterprises allowing for more entry and as a result also increased competition in the small firm sector.

On the other hand, large firms are generally dominated by self-perpetuating management hierarchies. Each one seems to have the characteristics of an island in a market economy. The planners and decision-makers must be taught to use the market as a source of information which can be utilized to the best of their advantage to increase productivities, efficiencies and competitive motivation. The best transition to privatization and thus stock-holding would initially involve the state as the majority stock-holder. This type of state ownership is compatible with a competitive environment if the state is only a passive owner, the enterprises have financial autonomy and are directly involved in international competition.

When considering the move to free market conditions from a command system, the question of the potential for competition in an economy arises. In general, competition dominates regulation. Under each particular reform situation, the policy experts should observe the inherent requirement to maintain budgetary discipline. In addition, analysis with respect to the needs for, and costs and benefits of subsidies and state enterprises would clarify a number of the existing inequitable situations. If enterprises are privatized, managers will be forced to work with revenues and profits and can no longer rely on the natural competition laming subvention. The timing of the implementation of free prices (price liberalization) as an essential element of the move toward competition is particularly crucial in the wake of the possibility of negative effects if this is done within the framework of a monopoly dominated structure. Structural disproportions can and will probably lead to an inflationary situation in the Soviet Union because the structure of production is geared towards primary products and the weakest links are consumption and infrastructure. It is true that liberalization can increase the budget deficit as a result of increases in industrial prices, wages, inflation, the cost of production and subsidies, but this may prove to not be detrimental to the economy if it is deliberately undertaken for stabilization purposes.

The policy items in the area of prices and competition, which must be dealt with in order to facilitate the transition from command to market economies, have different levels of priority. The following are the most important issues to be considered under the more general topic of prices and competition on the road of economic reform to a market system. A specific

look at designing an anti-trust law is needed. This is not the most urgent requirement, but increases in importance once privatization and price liberalization has gotten under way. Furthermore, a system of regulating what are referred to as public utilities in the western sense and known as public "properties" in the eastern sense. The reason for this lies in the fact that these are the areas where competition is felt to be deficient or even impossible for political and or social reasons, or because the entity is a "natural monopoly". In an effort to determine a system of price regulation for these types of situations, agreements must be reached between regulators, economists and accountants. The costs and benefits of regulating prices must be analyzed to determine whether such a policy would be economically justified. An additional question which appears crucial to the reform process is the designation of which sectors of the economy to regulate or deregulate first.

There are still more issues on the list of what is vital for policy reformers to act upon to encourage the transition to a market system. For example, investment funds (i.e., pension funds, etc.) and holding companies need to be created and managed. Of course, their functions in the new market economy must be carefully defined.

Moreover, the success of a reform hinges to a large extent on the advice of qualified practitioners, such as business people and accountants, whose experience in various areas including how to set prices and assess the value of capital assets can be applied. As a result, there will have to be extensive work on moving from dual-price systems to a system where the law of one price is not violated. In light of this trend toward deregulation and privatization the management of the public sector becomes a paramount question. Analysts and policy-makers must consider the alternatives of how the function of state enterprises must and will change with the liberalization and opening of the economy, and which measures are necessary to deal with possible undesirable effects and externalities that may arise expectedly or unexpectedly. With respect to the valuation of assets a substantial amount of technical help is required in the countries where there has been no "free" market activity has allowed prevailing demand and supply conditions to determine real asset values. Finally, a functional taxation policy is required to cover government expenditure on common property and social programs and simultaneously act as a type of market and social regulatory mechanism. While a general draft law is needed immediately, the laws with respect to taxation will have to be adjusted to properly accompany an economy in transition.



## Part II

# Capital Market and Privatization



# Capital Market and Privatization in the USSR

*Sergei Aleksashenko and Leonid Grigoriev*

*In 1699 Peter the Great prescribed that the Russian merchants should trade the way it is done in other countries, by companies, and by pooling together their capitals. But for lack of habit and trust, they were not doing very well.*

V.O. Kluchevsky (the renowned Russian historian, 19th century).

The experience of economic change in socialist countries, which has been under way for more than 20 years now, makes it possible to draw an important conclusion: if reform is to succeed and if economy is to improve serious system changes affecting all aspects of the economic life of society must be undertaken. The neglect of this requirement results in a situation where after some time the problems that were thought to have been solved reappear again in a new spiral of their development. And all the sacrifices that have already been made by society to achieve certain objectives, turn out to be in vain, for the very same problems call for more sacrifices.

The key problem, which is the focal point of any economic system and which must necessarily be solved, is relations of ownership. The failure to deal with them reduced to naught the results of even such a successful reform as in Hungary. The nearly full central control with regard to capital goods, which is characteristic of all the socialist countries in the near past, results in a situation where "a unified factory" mechanism is set up, the enterprises cease to be autonomous or enterprising, and it becomes impossible to determine directions for the most effective allocation (and utilization) of various

resources. It is clear today that these problems can be solved only through the creation of a full-fledged market encompassing goods, manpower, information and capital. The creation of a capital market is a problem of particular importance because it has to distribute financial resources which largely shape the state of economy for a long period of time. What is involved here is real investments.

### A. Potential Market for Equity

The solution of this problem is a difficult thing as is any reform on the whole. But it is made even more difficult in the Soviet Union by virtue of one fact: it must be started virtually from scratch; moreover at this point there are neither would-be sellers nor buyers. On the supply side things look bleak: the funds that can be put in securities are available to enterprises and to population, but their proportions are small. As of the end of 1989 the population had some 470 billion rubles, out of which 40 billion rubles were invested in state bonds in the 1950s and 1982, 165 billion rubles were "hot money" chasing the goods in conditions of shortages, some 100 billion rubles more were savings for major purchases (a condition *sine qua non* under an undeveloped system of consumer credits), and out of the remaining 170 billion rubles roughly one-half is "rainy day" savings. This leaves some 85 billion rubles which could potentially be invested as capital.

The enterprises are even less rich. By early 1990 they kept accounts in banks to the tune of some 100 billion rubles, out of which 33–35 billion rubles are incentive funds (clearly, the bulk of these will not be used as an investment resource). With the taxes fixed at a level somewhat in excess of 50 percent, the enterprises will retain some 125 billion rubles out of 258 billion rubles' worth of profits in 1990, while non-centralized investments are planned to be at the level of 95 billion rubles. As a result, the accretion of "free" financial resources of the enterprises will be rather insignificant (let us not forget the growth of inventories). The question is whether the wealthiest among them will deem it appropriate to be deprived of the cash "fat" which, it is true, is difficult to spend in the absence of the material resources market they still offered to enterprises in prescribed quantities anyway.

On the sellers' side the situation is even worse. At this time, virtually the only borrower is the state which is constantly short of money for current expenditures. The plans for 1990 are to cover the state budget deficit by selling a 60 billion rubles' worth to banks and 15 billion rubles' worth

bonds for the households. A decision was made at the end of 1988, which permitted state-run enterprises to issue securities. (They were called shares, although in terms of their characteristics they fall within the category of bonds with the right to call back.) Two types of securities are permitted till the spring of 1990: those to be distributed among members of work teams and among other enterprises. Some 150 million rubles' worth of shares have been released to date (March 1990), or less than one percent of the annual real investments.

It can be considered that a start has been made toward setting up a financial market, but there is no free circulation of either state enterprise shares or state bonds. No real steps have been taken so far to form a secondary market for securities. Even at this time when the government is adopted (19 June 1990) Interim Securities Regulations (which will remain in effect until the appropriate law is enacted), the creation of facilities for it is still only discussing.

It can be stated with confidence that a full-fledged capital market cannot materialize in our country until independent economic entities appear that would be able to meet both supply and demand. The solution to this problem is seen in a radical restructuring of relations of ownership and in implementation of a process of privatization.

## **B. Present Ways and Means**

It should be pointed out right away that the term "privatization" in the full sense of the word is not quite applicable to Soviet reality because the population's financial resources at the present time are clearly insufficient for acquiring a significant portion of the state property. It can be said that it is not their purpose and that their level, just like the median income level of the population, can secure only a comparatively small range of goods and services. On the other hand, this term is politically loaded – something that cannot be disregarded at least in the near term.

In this connection, to characterize the processes which are unfolding in our country it would be more correct to use the concept of "de-etatization" or disintegration of state property – which is perhaps more accurate at the first stage. These processes are already under way in the Soviet Union and it is possible to define their main directions.

- (1) The development of cooperative and individual labor activities. It is encountering tremendous difficulties, resistance and attacks from

conservative forces the society. But notwithstanding the movement is gaining in strength – on the basis of performance in 1989 the share of the cooperative sector in economy comprises 5–6 percent as against 0.5 percent in 1988. And this despite the fact that the cooperatives have been forced to operate in very disadvantageous conditions when it comes to acquisition of material resources, capital goods, production premises, etc. The cooperators are very insecure about their future (everybody remembers the government's decision passed at the end of 1988, which prohibits cooperatives – sometimes without any visible justification – to engage in certain activities); therefore they are not in a hurry to invest in capital-intensive technologies. Though cases are known cooperatives have purchased several industrial enterprises. A major role in the development of the cooperative movement will belong to republican and local authorities which determine the tax policies with respect to cooperatives. It appears that those regions stand to gain which will create acceptable conditions for the cooperators and attract them to themselves. This may result in saturation of local markets with some goods and services.

- (2) Enterprises on leasing contract. Unlike the leasing of capital goods, which is widely prevalent in many countries of the world, in the USSR the leasing of enterprises by work teams prevails. The enterprise as a rule is taken out of the administrative structure, out of subordination to a higher management body, and it arranges its relations with them on the basis of a contract. In principle, a work team may buy out an enterprise as its own property and transform it into a collective enterprise. From the viewpoint of common sense there is no difference between it and a cooperative enterprise, but again, by dint of some specific features of the social and political situation, their (non-existent) difference is highlighted.

At the end of 1989 more than 2,000 enterprises in industry and construction operated on leasing arrangements, some 5000 in agriculture and over 2000 in trade and public catering. There is an increasing practice of leasing structural units (such as workshops and sections) at enterprises. The performance of the enterprises has proved encouraging: their efficiency shot up dramatically initially but later began to decline. Some of the enterprises suffered from setbacks.

On the one hand, the trailblazers were allowed to operate on favorable terms and improved their financial status only after the transition. Later on their transition to leasing arrangements was not expected to be followed by changes in their financial status. On the other, a number of enterprises operating on the basis of leasing arrangements owe their

successful performance to their able and pushing managers who are real team leaders.

Some natural limitations have been identified, hamstringing future leasing arrangements. They prove most effective at small-size enterprises (where every team member is highly visible) with their short technological chains, flexible product lines, limited production assets and their ability to perform better by means of increasing labor inputs (such leased enterprises often work for 10 to 12 hours a day).

At present, leasing arrangements have mustered massive popular support, resulting in the emergence of a host of what we call collective, or people's enterprises. The strongest supporters of those entities (for example, Professor Bunich and the factory manager Bocharov, both are members of Soviet parliament) believe that leasing and collective managements should be introduced in a majority of government-run enterprises.

It appears to us that the potential of this type of enterprise and the role their teams of workers play in management are highly overrated. On the one hand, Russians have their traditional propensity for work-sharing arrangements (Russian peasant communities are a case in point). On the other, collective enterprises and workers' self-management in Yugoslavia provide clear evidence of their deficiencies: those enterprises gravitate toward maximizing the earnings of their team members, refuse to retool, and introduce advanced technology on, their production lines, resulting in human labor savings, lack of tools for balancing their current and longer-term interests with the former overemphasized and, as a result, "eat up" their accumulation fund assets.

Despite the massive support the enacted Law on Leasing is unable to bring any dramatic changes in ownership relations on its own. The scope of the law rules out its enforcement on a large scale, for access to leasing arrangements in agriculture is made contingent upon the good will of land holders, who are the chairpersons of collective and Soviet (or state-run) farms and they are represented in the Supreme Soviet in appreciable numbers. The massive transition of industrial enterprises to leasing arrangements runs into formidable obstacles put up by government ministries: leasing payments virtually prove to complement the main payments (taxes and so on).

We think that as a way to de-etatize the ownership relations leasing arrangements ought to be applied countrywide, mostly, in those sectors and

enterprises where the environment is propitious but those arrangements are unlikely to dominate or play a leading role.

- (3) Enterprises with a share of foreign capital (joint ventures). They have begun to emerge in our country since 1988, totalling over 1,000 now but their operation is not plain sailing. The reason for floating such ventures is easy to see: the Soviet Union wishes to lure foreign capital and technologies to upgrade its own economy. But there is a number of legal and economic conditions lacking to make them full-fledged. Firstly, we continue to lack legislation offering guarantees for our Western partners' investment. As a result, only about 10 percent of joint ventures have a credible footing for their production operations. Most of those ventures opt for operations that do not call for heavy investment in real estate. Secondly, there exists the problem of legislative stability, for our legislation may and does change overnight. Thirdly, there is an unacceptably large gap in the technical and technological levels of Soviet and foreign partners, resulting in Soviet matching contributions made in land and financial resources needed for current operations. And, lastly, the profits earned are impossible to spend: the Soviet ruble is not a convertible currency and that is the problem to buy something with rubles in the country or to invest it elsewhere, while if one starts looking for markets paying in hard money for one's products, one will give up one's market spot.

In the future if this form of ownership is to make tangible headway, our legislation should be liberalized substantially as a way of enticing foreign capital. But such a step will also entail obviating ideological stereotypes.

- (4) Stock-holding companies. We appear to pin our greatest hopes on such companies in pursuing a policy of de-etatizing our giant enterprises, in particular. Today we hold that this form of ownership will prove best suited to meet the interest of workers, who may become stock-holders, enterprises and our society.

Of fundamental importance is the fact that a stock-holding company reports only to a meeting of its share-holders and may not be run by any other governing body. It is true even of those companies where the state owns one hundred percent of their stock. Stock-holding companies should be made out of a majority of the enterprises in the state sector, primarily industrial ones including both large- and medium-size works that show profit or operate at a loss today.

The need for such a transition arises out of the advantages inherent in stock-holding as a form of ownership (which has proved its worth in



world practice over the last two centuries) compared to state, private, and cooperative ownership, especially for big-size enterprises.

### **C. To Sell or to Distribute**

Identification of those who will hold stock is crucial to converting a state-owned enterprise into a stock-holding one (newly floated companies are much easier to deal with, for their founding members distribute shares on their own). In the context of such a transition the pattern of stock distribution will, in large measure, predetermine the future development of the Soviet economy. Stock distribution is expected to boost economic efficiency and mold the mutual interests and responsibility of economic entities (that is, enterprises, banks, etc.) as well as personnel.

The most economically effective way (and the most feasible in our economic environment) to distribute stock appears to be the cross (or mutual) ownership of most of the shares by enterprises and organizations as well as credit and financial institutions of a new type to be established with the government's encouragement in our country. Stock held by individuals appears to be a fundamentally crucial but actually a secondary factor especially in large-size industries. Stock held by individual (nationals and by foreign physical and juridical persons) may be limited with regard to types of sectors. On the one hand, the level of earnings and savings of the population is clearly insufficient for buying large stock (we have mentioned that earlier) and their prospective rise will be geared mostly to increasing levels of consumption. On the other hand, tired ideological, social and political dogmas continue to exert a fairly strong influence on our society. Those dogmas maintain that owning large stock is inadmissible, for it will entail the formation of a group of rentiers, or investors. It will take us long to foster the positive image of entrepreneurship and all it stands for in popular consciousness.

### **D. The Implementation**

And now a few comments on the de-etatization program. This is how we see it implemented. No reform in the USSR may be successful if the agrarian issue is not solved radically, that is, the land problem. The notorious food problem may be solved only by peasants who are free to farm as they see fit, resulting in placing the entire edifice of reform on a solid footing.

The distinctive features of our country's development over the last 70 years make it impossible for a combination of various forms of ownership to emerge in a natural way. They should be established on orders from high on.

As the first step a department should be set up to manage state property, a body charged with transforming enterprises, enforcing compliance with national interests (this is all the more urgent now that more and more state-owned enterprises are converted into various types of associations operating under the auspices of public organizations, that is, they are no longer government-controlled, resulting in direct losses for our entire society), and with conducting all the activities needed to transform ownership forms.

Such a body will launch a system (fully owned by the state) of investment funds (financial holdings) on a sectoral basis (on the basis of current ministries) and/or a territorial one. Initially they will hold the stock of their "own" enterprises only, but later they will be able to buy shares of enterprises in other sectors with the money accrued from selling some of their stock and earning dividends. Some of their revenues will be used to pay for their participation in newly established enterprises.

Would-be investment funds will operate as profit-making entities so appropriate securities markets should be set up, including government obligations. Such funds become big credit and financial institutions and major tools for pursuing government economic policies in the context of an evolving market economy. As their major objectives, investment funds should focus on promoting such credit and financial institutions as commercial banks and insurance and retirement, or pension funds. This will give rise to growing savings in the country and improving government finances.

A criterion governing such companies' operations will be a ratio between profits earned as dividends and the work of shares and the government may rely upon that ratio in appointing enterprises selected for de-etatization.

The next stage will see retail trade and public catering entities, neighborhood services and small-size industrial enterprises start to operate on the basis of leasing arrangements. The enterprises that are unwilling to take such a step should be offered an option to be sold to cooperatives, or other interested persons.

At the same time, the government should take a decision to convert 200 to 250 giant enterprises into stock-holding companies that will exchange their stock.

Investment funds will issue enterprises' shares that will be owned as stock and mount stock subscription campaigns among enterprises, organizations,

credit and financial institutions, teams of workers employed by those enterprises and all the Soviet nationals. As a result, a new structure of stock property will take shape in the country. Programs are now being designed to sell shares on a step-by-step basis (with all the rights as provided for in international standards).

Investment funds determine the worth of shares that will be issued by evaluating enterprises' current and projected cost effectiveness and by appraising their assets and financial status (especially with regard to enterprises that operate at a loss).

After a decision is taken to convert enterprises and appraise their worth, big numbers of shares will be acquired free by the following entities: the government through an investment fund, local government bodies and enterprises themselves. The latter entities are crucial in that the team of workers employed by a given enterprise gains a chance to influence their enterprise's performance through their representative on the board.

Initially the government should have 60 to 70 percent of shares, some of which any other juridical and physical persons are entitled to claim after a share-holding company has been floated. In taking a decision to convert an enterprise the government may determine the minimal size of the stock it will hold in the enterprise's ownership assets but not greater than one-third. Shares over and above that ceiling should be sold as soon as they are in demand.

The share-holding companies converted from government-owned enterprises conduct their operations in conformity with legislation governing share-holding companies. The status of those companies does not depend upon the proportions in which shares were distributed among share-holders: investment funds, credit and financial institutions, stock-holding companies, Soviet nationals, etc. In other words, after an enterprise was taken over by share-holders as their property, it is the share-holders and the persons they select or appoint exclusively who may take decisions.

Investment fund representatives have no voting privileges in decision-making and, as a result, government institutions may possess a controlling interest virtually for a long time (plus restrictions in individual sectors). Foreign capital should be encouraged to acquire stock on a massive scale.

Of special importance is the future of payments used to acquire shares that will be sold on the market. The worst decision that may be taken is to count those as the government's current revenues, leading to the "eating up" of the people's property. It appears that a good decision ought to be made along the lines of spending the funds to pay for our domestic debt

that has been accumulated in contravention of the due process of law (it totals about 300 billion rubles) and of depositing those funds in special investment funds for the government to finance production-unrelated facilities and infrastructures.

The next stage should see a program designed and implemented with a view to converting the remainder of government-owned enterprises into stock-holding companies step by step according to a similar scenario. Such a massive conversion is basically the takeover by the public of government property.

The implementation of the program will be centrally managed, though up to a point. At the same time, from the very outset of this stage all government-owned enterprises that have bonds and securities issued in excess of 20 percent of their ownership assets should be automatically converted to stock-holding companies regardless of the program.

Concurrently, at the end of the first stage and in the beginning of the second one, financial market institutions are expected to be floated: stock exchanges, property appraisal firms, holding companies, investment societies; an interbank money market will gain in scale.

Now a few comments on the time limits of the process. The first stage should be sufficiently brief (two to three months long) and the second one should start immediately after the first stage and may last for five to ten years. Afterwards we may hope to succeed in obviating the negative factors that were generated by our etatized economy.

# Privatization in the USSR: Necessary for Structural Change

*Anatoliy B. Chubais and Sergei A. Vasiliev*

Distorted structure of the Soviet national economy is the main reason for the recent financial crisis. Restrictive financial policy makes the latent structural crisis the open one. There are two stages of inevitable and painful structural reform. The first stage is connected with purging economic structure of the obsolete production units. The second one is to be the intensive process of high technology sectors creation. The shift toward the second stage will be successful only if there is the mechanism of the rational investment choice and capital movements. Private investor has to be the “dramatic personal” of this mechanism. Thus, the privatization appears to be the main condition of structural reform in the USSR.

## **Problem Nr. 1: Financial Crisis and its Profound Roots**

Nowadays the problems of the economic reform, as well as those of technological development fade in comparison with the heavy financial crisis. The crisis is only partly due to the arbitrary actions such as the alcohol legislation.

The process of perestroika made the ministries more dynamic and gave them excellent opportunities of obtaining cheap investment funds from the budget, thanks to confusion on the highest level of management. On the other hand, the social expectancies connected with perestroika made

inevitable the growth of expenditures on social insurance and social infrastructure.

All this made the financial situation worse but was not the basic cause of the crisis. We should mention here that the rapid growth of nominal incomes of the population began already in the sixties, while the total mass of money hardly began to grow faster in the recent years. Those who talk about the recent emergence of budget deficit forget about the dynamics of debt money. Up to the beginning of the eighties the debt money grew rapidly from 126 billion roubles in 1970 up to 520 billion roubles in 1985. Since 1985 the mass of debt money has been almost constant, on the other hand at this time the state budget deficit has been growing. As a matter of fact the credit emission was substituted in the middle eighties by the budget emission.

We only consider the present financial crisis to be the summit of a prolonged socioeconomic structural crisis connected with decay of the centrally-planned economy. The sharp decline in growth rates in the mid seventies was the starting point in its development. This sharp decline can only be explained rationally if we consider the features of resource distribution in the centrally-planned economics.

The characteristic feature of this system is its incapability to redistribute financial and material resources among the departmental substructures of economy.[1] The development of new branches (high-technology sector) is limited by the current accumulation fund, while the old branches are functioning in regime of stagnation or even of slow expansion. When the outer resources guarantee a high rate of extensive growth, a substantial share of accumulation fund can be invested into new branches, which define efficiency level of the whole economy.

The crash of such growth mechanisms as a result of tightening of the resource constraints [2] and of general entropy processes during the Brezhnevite epoch put an end to the above-mentioned type of technological development. From the mid seventies a serious shortage of financing of implementation of advanced technologies has been perceived and the output-capital ratio has substantially decreased.

There is no need to analyze the different manifestations of the Soviet crisis to see that the exit from the crisis is connected with long-run dynamization of national economy on the basis of new technology.

Such dynamization requires the fulfillment of the following conditions:

- First, a high rate of accumulation, because new technologies are capital-intensive.

- Second, intersectoral resource redistribution in favor of advanced branches of economy.
- Third, the presence of mechanism which provides a rational choice between investment projects and the effective use of investment funds.

Exactly from this point of view we shall evaluate present measures of financial recovery and economic reform, as well as the global economic perspectives of the USSR.

### **Nearest Consequences of Restrictive Policy**

In the course of economic reform reductions in military and investment spending will sharply diminish the social demand for the output of the heavy industry, while the market orientation of enterprises will cause a reduction of intermediate consumption.

The reduction of the demand can be compensated by different measures of economic policy: some branches of the heavy industry are capable of producing consumer goods (residential construction instead of nonresidential, the equipment for light and food processing industries, durable consumer goods). At the same time even the effective compensation will not permit to keep the production of traditional machinery on the existing level.

The reduction of investment and intermediate demand creates a situation of a profound structural crisis in Soviet heavy industry. As the input-output calculations show, only planned investment restriction will reduce demand for tractors, lorries of middle-carrying capacity, locomotives and railway carriages, turbogenerators and other heavy machines by 20–60 percent in the next 3–5 years. The machinery is overproduced in Soviet economy and the rationalization of the economic ties will bring the existing surplus into market. The reduction in production of heavy machinery means a recession in the metallurgy industry. The railroads will be delivered from the substantial part of heavy loads, the route turnover of carriages will be normalized, and demand for it will fall. The stagnation in the heavy industry reduces industrial consumption of energy and affords to restrict the construction of power stations.

Under such circumstances the structural crisis turns from the latent form into the open one. The overproduction in the heavy industry is a main obstacle to financial recovery: such industries as metallurgy and coal extracting cannot change their production profile.

Even if enterprises in these industries are closed, in many cases it will be necessary to pay wages to the workforce from the budget.

## **The Essence of Restructurization**

Non-viable enterprises can be closed or converted, but in any case we observe here a deep structural change in the economy. Among the features of this process we should mention the following:

- First, it is a forced structural change induced by the financial crisis and economic reform.
- Second, this structural change is by definition connected with utilization and conversion of existing production capacities, and does not require much investment.
- Third, this structural change is oriented at nonproductive consumption and not at technological development.

We call this process “a restructuring” and not a reconstruction, because we do not construct anything in this period, but only purge the economy of obsolete technological systems and branches.

One should take into consideration the advantages and the disadvantages of a restructuring. Its positive effects allow the living standards of the population to rise substantially by utilizing the existing industry capacity: the machinery can work until its physical wear and tear, and the workforce – until their pension age. The structure of economy is adapted to the real social needs, the conditions of operation become more even for the majority of enterprises.

Among the negative consequences of restructuring we should mention a stable decrease in rate of accumulation, which will be hard to be reversed, and a possible decline of high-technology in capital-goods and defense industry: the existing R and D potential of these branches as well as the qualification of its workforce are not used efficiently when they produce consumer goods. All this is very important on the eve of large-scale reconstruction of the national economy, based on technological achievements of post industrial economies of the West.



## Contradictions of a Technological Reconstruction

The perspectives of further technological development of the USSR (after the end of the restructurization process) rouse our serious anxiety. The investment restriction is a necessary condition of the successful reform process, which has been many times used in practice, for example: the USSR in the period of NEP (1922–1924), Yugoslavia (1955–56), Hungary (1970–1971), China (in early eighties), Poland (1990). Such restriction prevents from carrying out inefficient investment projects, but it does not provide a mechanism for rational decision-making in this sphere.

The investment restriction cannot last for a long time and all the above-mentioned cases were followed by inefficient invest booms.

The mechanism of inefficient investment in socialist economy has been studied thoroughly [3] and now we can see that neither the state nor self-managing enterprises can pursue the efficient investment policy. Self-managing enterprises have only profit (revenue) incentives and low propensity to accumulate, while in state structures bureaucrats also do not bear the responsibility for the long-run consequences of their decisions.

The response to inefficient social investment displayed in demands of “privatization”, at least in form of worker’s shares. In order to provide incentives for the workers to invest rationally these shares have to be evaluated permanently at financial market, that is to be transferrable one way or other.

But this mechanism provides for intersectoral transference of capital in less degree as the rate of stock turnover in this case is rather low. The rate of accumulation is also low thanks to the workforce propensity to save up. “People’s capitalism” in any case may only play an auxiliary role, especially under conditions of technological reconstruction.

## “Dramatis Personae” of Technological Reconstruction and Their Motivation

In our considerations we see now a figure, which arises from historical non-existence – the figure of a businessman–entrepreneur, which has enough capital to bear the investment responsibility and enough technical knowledge and willingness to support the innovative activity. Unfortunately, these conditions do not coincide in our country.

Those who have capital have acquired it in different spheres of illegal activity and are mostly ignorant; while scientists and white collars have small money savings. But it is not the main point.

Inflationary tendencies and political instability will exist in this country during a long period of reconstruction. Under such circumstances even the businessmen of "R and D" origin will think twice before financing innovation projects with long gestation lags, while the former activists of the shadow economy will undoubtedly invest their money into tertiary labor intensive industries, such as trade, tourism, catering.

Private capital will pour in a broad flow into development of new technologies only when capital is overaccumulated and political guarantees for private investors are reliable enough. Those conditions have matured for a long time.

Understanding the unreliability of private investment in the process of technological reconstruction, some of the Soviet economists are ready to preserve the system of social investment in non-state form.

There can be created big intersectoral concerns. Investment banks, innovation foundations can unite available assets of enterprises and population with financial resources of State. Such a mechanism presumably provides a high rate of accumulation and rational choice of investment projects. This rationality is provided only by professional and organizational incentives of managing and technical personnel in these organizations. The business motives of the rational investment behavior are weak here, unless some type of share bonuses is introduced for those employers which take part in decision-making on concrete projects.

The most vulnerable point of those institutions is the absence of a personified capital owner. This fact opens wide possibilities for diffusion of non-economic criteria into their activity. Effective political pressure and personnel corruption are practically unavoidable: "nobody's property" sooner or later finds an owner.[4]

There are also social barriers on the way of technological reconstruction, besides the problem of its subject. The required increase in the rate of accumulation occurs after a comparatively long period of its low values. This increase will not have an immediate effect on the growth rates and especially on consumption level. The halt in consumption growth will be very painful, as well as a continuing resource transfer from consumer goods sector into high-technology industry. Social tensions and political conflicts will be inevitable.

## Some Possible Recipes

We do not see a way to get over these contradictions. It is obvious that the alternative to technological reconstruction is the further widening of the gap between the USSR and the Western world, a complete transition of the country into the Third World and its prolonged stagnation as a resource appendage and a rubbish heap for world economy. That is why we have to pass the way of technological reconstruction, long and agonizing it may be.

Along this way not only technology basis should be reconstructed, but also property relations, political structure and socio-psychological behavior have to change.

What we suggest is not a complex system, but a compromise set of measures, which provide only suboptimal pattern of reconstruction.

Our main idea is to connect individual entrepreneurial activity with financial resources of society. A person or a group intending to invest their own capital into technological reconstruction (R and D, venture projects, reconstruction of factories and plants) should have an access to the additional sources of social capital.

While the primary responsibility for rational use of capital bear entrepreneurs (by their shares), the total amount of investment is much greater than individual capital. Thus, the high rate of accumulation is secured.

Organizational forms of such joint investment can differ from small venture firms in high technology R and D to large joint stock corporations. The shares in those corporations should be dispersed between different holders (the State, municipal Soviets, investment foundations and banks, employees of enterprises, population) in order to exclude one-side political pressure in process of investment and technical policy elaboration.

Stock companies can quickly mobilize financial and material resources needed for the development of new basic technologies. But a provision of technological development by workforce and infrastructure services is also a rather complicated task.

During the restructurization period substantial financial resources will be invested into the existing social and infrastructure. As a result of this sequence of economic policy measures (at first restructurization, the reconstruction) technological reconstruction will be oriented at the traditional system of territorial organization of economy. An additional argument in favor of such strategy is the low mobility of population in the USSR.

That is why the new production system will be created on the base of the rebuilt enterprises of traditional technology systems, and the organizational

form of this transition is the absorption of the old enterprises by the new corporations.

The processes of restructurization and reconstruction are no compatible due to the differences in accumulation rates and economic policy priorities. But even during the restructurization period there can be carried out some preparatory steps in the direction of reconstruction.

Thus, the research and development activity on the principal directions of technical progress should be activated. The majority of thoses directions is well known thanks to the western experience, and the existing R and D structures are advanced enough for technological break-through in some areas.

Such a policy will preserve the existing R and D potential, especially in defense industries, subject to conversion. The output of Soviet high-technology industries may find its way to foreign markets, where Soviet wares can win a competition only thanks to their low costs of production (when accounted in hard currency according to the present low real rate of exchange).

Foreign investment in the Soviet Union and joint ventures can also play a significant role not as an aid, but as a means of adaptation of Soviet economy to World market and of training Soviet people in the spirit of entrepreneurship and business. The temporary work of Soviet specialists abroad is a step in the same direction.

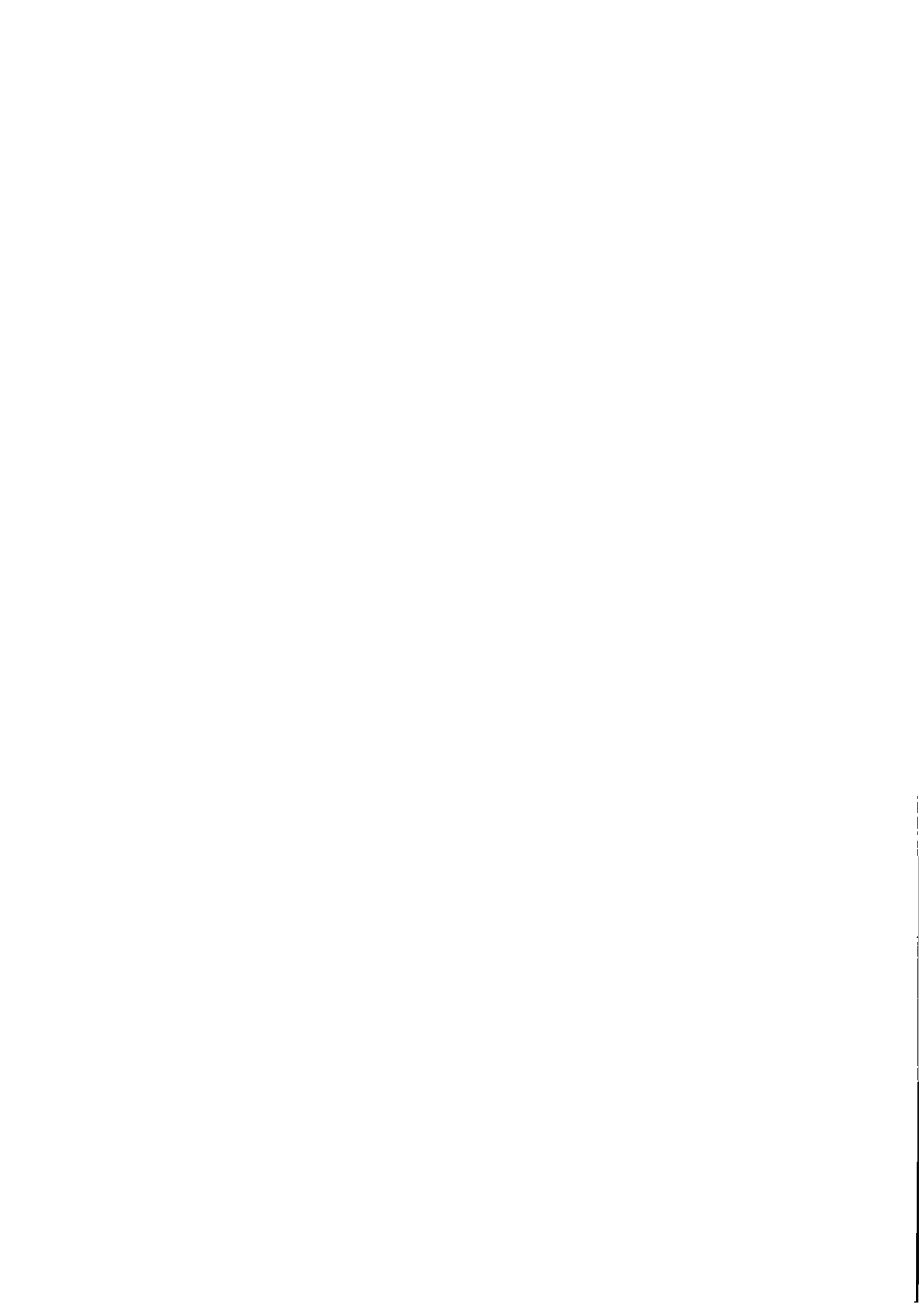
Last but not least: social support of entrepreneurship in R and D sphere: Talented scientists and engineers should receive high incomes not as a salary, but as a royalty on sales from the firms which use the result of R and D.

Small high-technology firms should enjoy different allowances and get and access to services of state-owned R and D infrastructure (computer network, information and leasing centers etc.). Small firms can be seen as a potential base for future development of large high-technology corporations.

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# Comments on the Paper by S. Aleksashenko and L. Grigoriev

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## Foreword

I found the paper by Aleksashenko and Grigoriev extremely interesting and I want to elaborate on five points in order to set a stage for further discussion. In the process, I may try to inject some Japanese view, not because I am from that country, but because that country has emerged from a capital scarce economy recently and may have institutional set-up which is relevant to the topic of the session. In addition, Japanese experiences in privatizing public corporations in recent years may have direct bearings on our topic.

## Problems of Ownership, or the Roles of the Privatized Sector and the Public Sector

It is only natural that the authors focused on production sphere (i.e., means of production) when they said “the key problem, which is the focal point of any economic system and which must necessarily be solved, is relations of ownership” [Aleksashenko and Grigoriev, p. 49]. Abolition of private ownership as means of production has been the backbone of socialist economic thinking. At the height of the controversy on convergence of economic systems in the 1960s, economists in the West tended to emphasize the changing functions of market economies on the one hand and planned economies on

the other, and admitted the converging trends. In contrast, economists in the East disagreed on the ground that the forms of ownership are distinctly different in the two systems.

A question then arises: what kind of mixture are we talking about in discussing the economic reforms? Even in a market economy, there exists public sector of considerable size. In the U.S., which is the champion of the market economy, the magnitude of resources which goes through public channels amounts to 40% of GNP (we include here final demand and income redistribution through social security). The picture is the same in Japan. In Western European countries such as FRG, France, and the U.K., the ratio is about 60%. Even in the Soviet Union, on the other hand, the share of public sector is not 100%.

In the Soviet Union today, majority of enterprises are owned by the state. "They are subordinated in administrative terms to ministries and other state bodies, and must carry out their orders" (Yasin). Instead, various forms of ownership are being discussed. Suggested forms include the following.

- (1) Cooperatives.
- (2) Leasing of enterprises by work teams.
- (3) Enterprises with a share of foreign capital (joint ventures).
- (4) Stock-holding companies.

Greatest hopes are placed on the last one. Soviet economic reformers are thinking in terms of converting state-owned enterprises into stock-holding companies. "A stock-holding company reports only to a meeting of its shareholders and may not run by any other governing body [Aleksashenko and Grigoriev].

Much more discussion should be devoted to the functions of ownership. Forms of ownership does not uniquely define the functions of ownership.

By the "functions of ownership" I mean (a) Who runs business, capitalist owners or specialized managers? Their motivation may be altogether different. In the market economies, tendency has been the separation of ownership and management. Business firms are increasingly owned by institutional investors such as life insurance fund, and management is relegated to specialists. (b) Who controls the profit? It can be consumed by owner-capitalists, distributed to employees, taxed away and spent by government, or reinvested by the business.

One of the important functions of the capital market is risk taking. This is because investment is the act of realizing technological change, rather than perpetuating the existing practice. This fact gave rise to various forms of



organizations such as venture capital, spin-offs which often organized as subsidiaries, consortium (research, etc.), subcontracting, network organization, so on and so forth.

Behavior of various forms of ownership has to be analyzed from this perspective.

## Channeling Savings into Investment

Why privatize? It is because market mechanism is believed to be conducive to:

- (1) Production processes which reflect new technological possibilities and changing factor prices (wage rate and interest rate).
- (2) Stringent managerial responsibilities.
- (3) Efficient logistics, shorter construction period, and faster turn-around time.
- (4) Quick response to changing demand

But in a society where investment demand exceeds savings fund, interest rate will be driven up if its determination is left for the market. This will make investment in plant and equipment economically unjustifiable because of the long gestation period and heavy financial risks. The same can be said of R&D expenditures. Speculative transactions, which typically do not involve production, may become attractive.

An alternative is capital rationing where capital is allocated at a lower-than-equilibrium interest rate and funds are allocated according to some priorities. But, this presupposes sectoral priorities. Who sets the priorities? Government ministries? Thus, we are back to where we started – central planning.

It seems imperative to introduce market test for investment projects. Allocating resources by government decree has proved an inefficient way of running an economy, and this is true in the West as well as in the East.

In Japan, for instance, savings are channeled through two routes. The one coming through public channel is usually mixed with private funds, and investment projects are almost always drawn up by private business. Thus, any project has to meet the test of the market (see *Figure 1*).

Projection on future demand is often discussed at industry level (various industrial organizations such as iron and steel, automobiles, electrical machinery, etc.) at an aggregated government-industry level (Council on

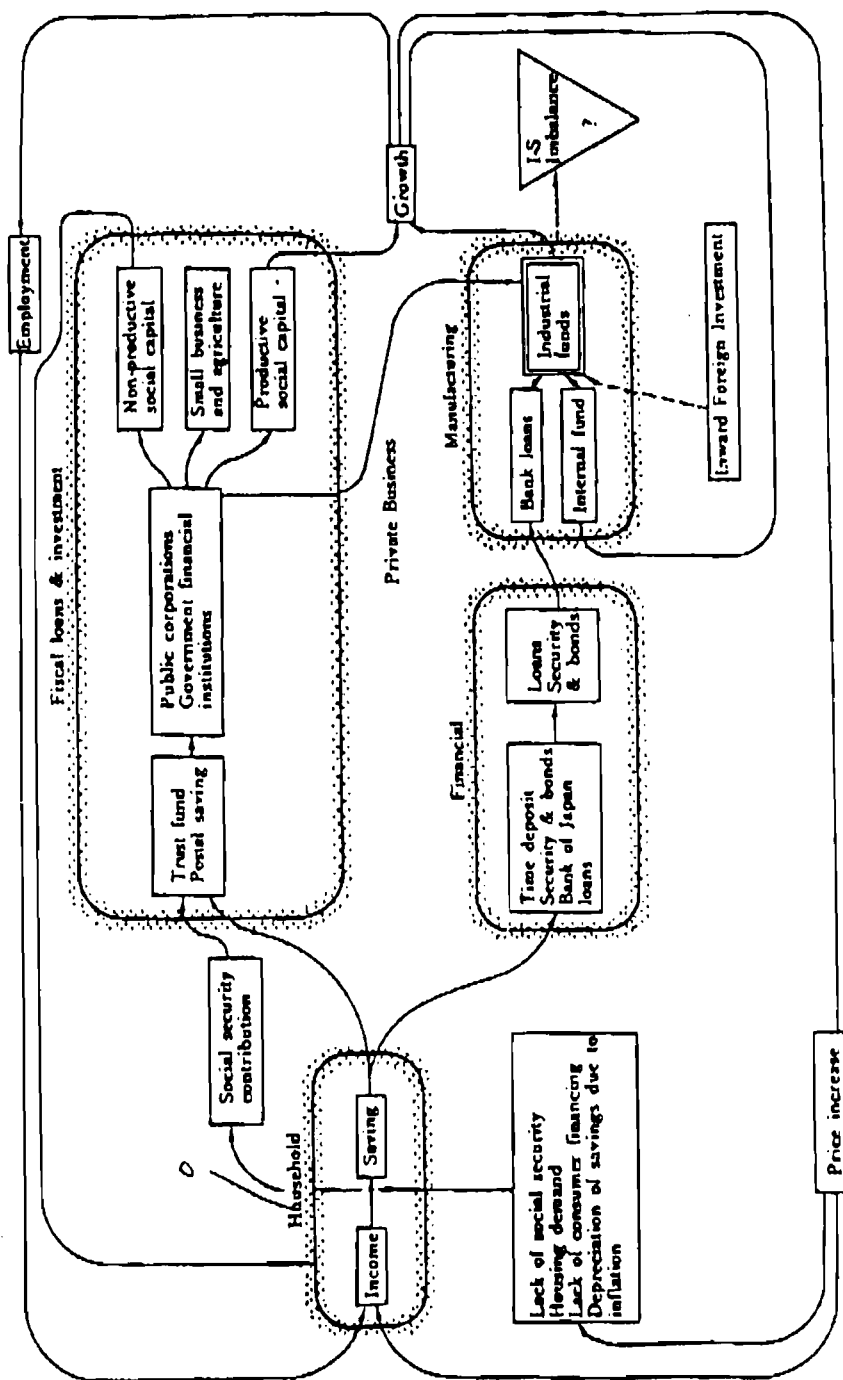


Figure 1. Channeling of saving and investment.

Industrial Structure). This is a checking mechanism regarding interindustry repercussions (real side of the economy) and availability of investment fund (monetary side) [Uno, 1987].

## Privatization, How to Get from Here to There

The government should take a decision to convert 200 to 250 giant enterprises into stock-holding companies that will exchange their stock. . . . Programs are now being designed to sell shares on a step-by-step basis (with all the rights provided for in international standards). As the first step a department should be set up to manage state property, a body charged with transforming enterprises, enforcing compliance with national interests.

Such a body will launch a system (fully owned by the state) of investment funds on a sectoral basis and/or a territorial one. Initially they will hold the stock of their "own" enterprises only, but later they will be able to buy shares of enterprises in other sectors with the money accrued from selling some of their stock and earning dividends. [Aleksashenko and Grigoriev]

We know how a market economy functions once state-owned enterprises are privatized. What is crucially important is the process of transition. In this sense, privatization experience of major public corporations in Japan may be worth close scrutiny.

The case of privatization in the Soviet Union is not exactly the same as the case in Japan. For one thing, capital market already exists and private citizens as well as financial institutions are used to purchasing stock. This involves risks, the price of stock may go up, but it may go down. Market mechanism works generally well when the adjustment is marginal. But the privatization in the Soviet Union is far from marginal.

Secondly, a mechanism exists whereby market value of the entity being privatized can be assessed. Through the market test, fair price can be set. If, however, there is no market evaluation, price can be set arbitrarily low, resulting in windfall profit for the purchaser. Even in market economies, insider transactions are strictly forbidden for this reason. If the firms are sold at a bargain price in the course of privatization, public at large will suffer hidden loss of losing public property to private hands.

A few words are in order on Japan's public corporation system. Recent privatization in Japan had its focus on three public corporations in railway transportation (JNR: the Japan National Railways), telecommunications (NTT: the Nippon Telegraph and Telephone Public Corporation),

and cigarette production and distribution (JTS: the Japan Tobacco and Salt Public Corporation).

They are in general characterized as follows.

- A special corporation separated from the government structure.
- 100% share held by the government.
- Limited business activities.
- President and vice president nominated by the cabinet.
- Budget decided yearly by the Diet.
- Limitation on budget transfer.
- Fund raising and bond issuance must be approved by the Ministry in charge.
- Independent fund operation not allowed.

Despite their aims of achieving efficiency while attaining public service function, they have grown into bureaucratic organizations of gross inefficiency. Such development is attributed to the following factors.

- Lack of self-determining power: budget, fees, investment plans, wages, among others, have to await government approval.
- Political intervention: people's expectation on public services, coupled with politicians' desire to gain voters' support, tended to put pressure on public corporations and bend their decisions.
- Unusual labor relations: strikes are prohibited for the workers in public corporations in order to safeguard uninterrupted services, while, actually, frequent labor disputes have been experienced.
- Managerial responsibility was obscured by the above.

External intervention, managerial deficiency, and abnormal labor relations, in addition to prohibition of entry into new business field other than stipulated in law, made public corporation inefficient. Inefficiency alone does not invite business failures. They have turned into unprofitable entities due to loss of monopolistic position, which in turn was the result of technological change in respective fields.

The Provisional Commission for Administrative Reform in early 1980s recommended privatization of public corporations. Actual process deferred slightly in each case, but the general thrust can be observed in the following steps stipulated for telecommunication corporation NTT.

- NTT's status shall be changed from a public corporation to a special corporation as a provisional measure.

**Table 1.** Profit and loss of corporations after privatization. (Billion yen).

	FY' 84	FY' 85	FY' 86	FY' 87	(Estimate) FY' 88
<i>1. JNR &amp; JR Companies (since 1987)</i>					
Total revenue	3,559	3,725	3,944	3,821	3,718
Total cost	5,209	5,573	5,305	3,665	3,588
Profits (before tax)	△ 1,650	△ 1,848	△ 1,361	156	130
Profits of the year	-	-	-	50	63
Deficit (JNR Settlement Corp.)	-	-	-	△ 1,170	N.A.
Manpower (in persons)	358,065	326,025	276,774	202,671	N.A.
<i>2. NTT &amp; new NTT (since 1985)</i>					
Total revenue	4,756	5,091	5,354	5,662	5,613
Business expenses	4,429	4,407	4,631	4,841	4,925
Business profits	-	684	728	821	688
Profits (before tax)	328	316	358	497	425
Profits of the year	-	141	148	243	233
Manpower (in persons)	326,546	309,201	300,488	294,422	N.A.

- The government shall hold all shares of this special corporation.
- Within 5 years, NTT shall be reorganized into a central company managing trunk telecommunications lines and a multiple number of local companies offering telephone services to local communities.
- Other companies shall be allowed to enter the trunk telecommunications line market (introduction of competition principle).
- Until the reorganization, ...rationalization measures shall be applied to NTT, such as reduction of work force, separation of its customer's premises equipment department and data communication department.

The progress of privatization of NTT is depicted in *Figure 2* which shows public offer of shares held by the government. As for the results of privatization in terms of efficiency of management, data provided in *Table 1* give us clues. We may say that the outcome has been favorable.

A mid-way between state ownership and privatization is leasing arrangement. Leasing arrangement has the advantage of avoiding manipulation of capital market by "insiders" of previous enterprise administrators. While capital market is yet to be implemented, step-wise formulation of market valuation of enterprises through leasing seems to be a feasible solution.

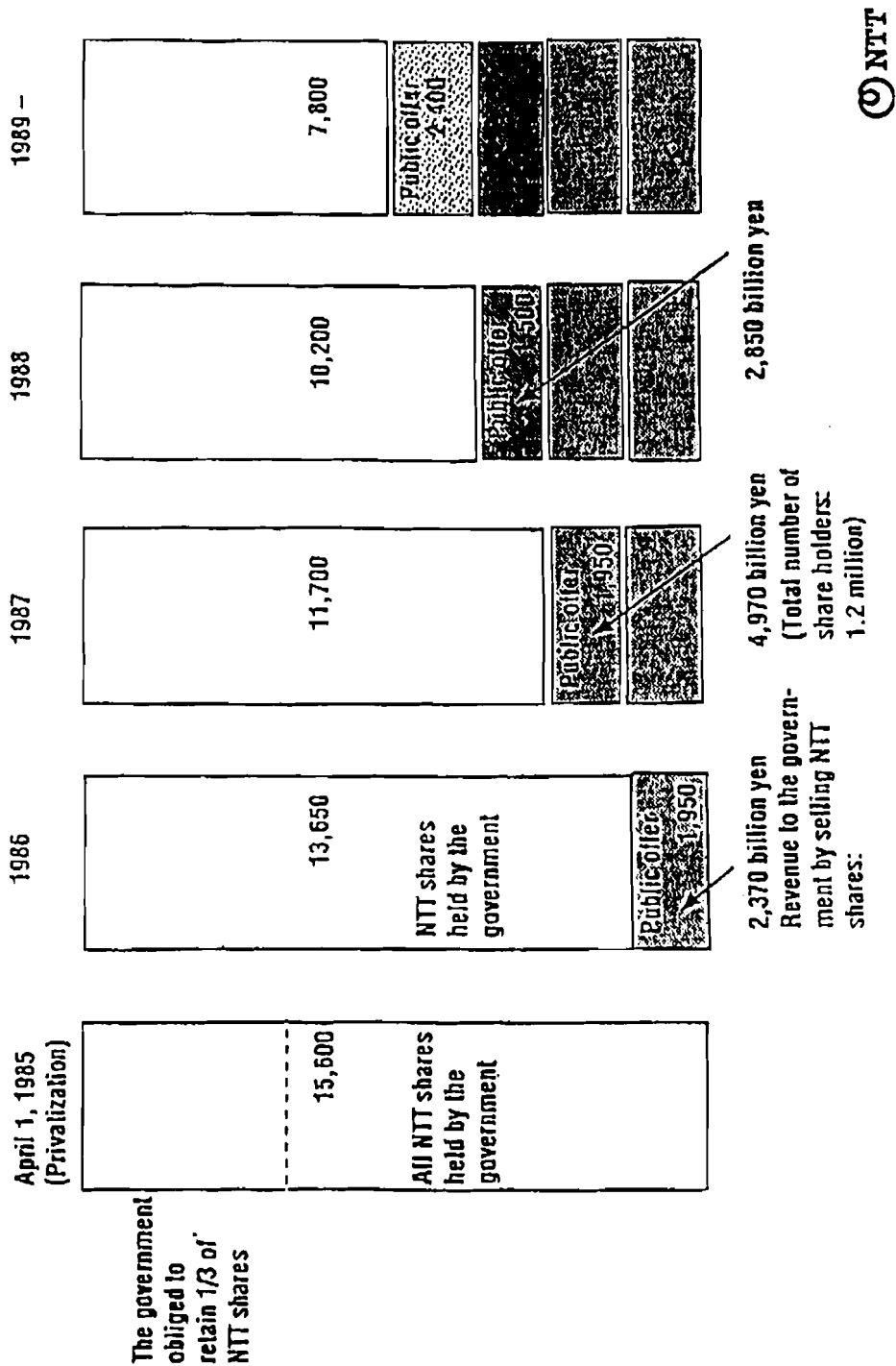


Figure 2. Government holding of NTT shares and public offer.

## Capital Market and Technological Change

Authors stress the creation of full-fledged market in the Soviet Union.

It has become impossible to determine directions for the most effective utilization of various resources. . . . these problems can be solved only through the creation of a full-fledged market . . . manpower, information and capital. The creation of a capital market, or a financial market, is a problem of particular importance because it has to do with the distribution of resources which largely shape the state of economy for a long period of time. What is involved here is investment. [Aleksashenko and Grigoriev]

Decisions on employment and investment are based on relative price of labor and capital. Thus, we are concerned with an integrated factor market. Labor market determines price for labor (= wage rate), capital market price for capital (= interest rate), and goods market price of capital equipment.

In earlier days before full employment was achieved, economic growth did not necessarily mean rising income levels. Also there are indications that the labor's share in GNP tended to stay constant or decline. A scheme on economic development of labor-surplus economy suggested by Ranis and Fei is particularly appropriate in this context. Their theorization explains why the interest of workers (who are interested in consumption in the current period) and that of capitalist entrepreneurs (who are interested in investment for the future) tend to diverge.

But things are altogether different after the full employment is achieved. Capital accumulation necessarily leads to rising wage levels. What is more, capital is increasingly owned by working class directly through acquisition of such capital securities. Even when they do not purchase stocks directly, life insurance, retirement fund, etc., put their money in the form of stocks.

Important thing is that the relative price of labor and capital determines the characteristics of production technology. When the labor becomes scarce and hence the wage rate higher, business firms are obliged to adopt labor saving, capital intensive technology.

This point is confirmed empirically for the diffusion of industrial robots, NC machines, computers, and other high-tech, which has been the focal point of CIM (computer-integrated manufacturing) project at IIASA of which I am a member.

Privatization moves the decision making from the top to the bottom. And the bottom-up decision making, as opposed to top-down, is absolute necessity for smooth diffusion of new technology because only at the plant level one can evaluate the potentials of new technology. Technological

potentials are very difficult to gauge at the top level. This also underscores the importance of free flow of information.

It is also important to see the roles played by the financial institutions. Banks, themselves competing each other, evaluate new investment plans by private business and expand credit for the promising ones. Competition in financial spheres is another vehicle through which technological innovation is realized.

## Need for Monetary Statistics

According to authors, "Population's financial resources at the present time are clearly insufficient for acquiring a significant portion of the state property." While at the same time, "Ideological, social and political dogmas continue to exert a fairly strong influence on the society, which maintain that owning large stock is inadmissible for it entail the formation of a group of rentiers, or investors." Therefore it is suggested that "cross ownership of most of the shares by enterprises and organizations as well as credit and financial institutions of a new type is suggested to be the most effective way" [Aleksashenko and Grigoriev].

Accusation on ideological grounds can be dealt with in a scientific manner as we have discussed above.

We are here concerned with a problem of formulating the privatization and creation of capital market in operational terms. This cannot be done by decree. In order to approach the problem of creation of capital market in a systematic way, and to start talking in operational terms, we need flow of funds statistics regarding the flow of financial resources and assets and liabilities statistics regarding the stock. The framework should include sectoral breakdown, such as government, financial institutions, business, household, and the rest of the world. One may wish to distinguish central government, local public bodies, and public corporations. Financial institutions can also be broken down into the central bank, private financial institutions, and public financial institutions. Each sector has entries regarding their assets and liabilities.

Then we can talk about transforming one form of asset (e.g., cash holdings) into another (e.g., stocks, bonds, etc.). Potential roles of pension plans, life insurance scheme, etc., can be explicitly examined.

This is also essential from the viewpoint of avoiding inflation. Monetary side should be kept in pace with the real side. If the government turn to



deficit financing, and business into mutual borrowing, the aggregate demand may easily exceed supply potential.

Under inflation, it will be extremely difficult to persuade people to purchase financial assets with fixed interest rates because it is the sure way to lose money. Inflation, coupled with privatization, will make speculation more profitable than real investment which takes many years before turning out yields.

“A banking system capable of regulating money supply will be an important element in achieving financial recovery. The present system based on centralized distribution of credits and administrative control over the activities of loan recipients is ineffective because it can be bent by state and party authorities” [Yasin]. If capital market is to be created and made functional, then statistical system which is capable of monitoring the market performance is undoubtedly indispensable.

## Further Remarks

Questions for future research for the study group on capital market and privatization seem to include the following.

- Banking system:
  - (1) Two-tier banking system.
  - (2) Role of central bank, political independence.
  - (3) Creation of financial market to implement monetary policy (open-market operations).
  - (4) Assessment of credit-worthiness of firms.
  - (5) Market clearing interest rate vs. capital rationing.
- Non-banking financial system:
  - (1) Timing of stock market implementation.
  - (2) Roles of enterprise management.
  - (3) Life insurance and other forms of insurance.
- Stock-holding companies:
  - (1) Theoretical justification.
  - (2) Appropriate forms of ownership, large enterprises vs. medium- and small-sized firms.
  - (3) Assessment of the values of the firms.

- (4) Procedure for privatization.
- (5) Merit of leasing arrangement.
- (6) Who is to own the stocks, including the roles of government investment fund.

These topics will have to be elaborated further for the economic reform and integration process in planned economies. There are undoubtedly ample experience accumulated over the years in planned economies as well as in market economies. There are also theoretical inquiries on the performance of various institutional arrangements. We need to mobilize this body of knowledge in order to come up with a consistent set of policy prescriptions.

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# Summary of Discussions\*

*C.M. Schneider*

When speaking about economic problems and reform, the distinctions between stocks and flows in an economic system must be clear. The basic build-up of capital markets is central to the success and failure of a move to a market economy. Within the realm of business of the banking system, an allocation of the flow of savings among diverse investment applications to create new investment opportunities becomes essential. Although the flow problem is present, it is the stock problem which is much more serious and basic. There should be a transfer of the stock of current assets from their present form to a productive stock in a new form where the stock can accrue. The steps of a reform should first deal with the stock problem before turning to find a solution to the flow problem. Essentially, the stock problem refers to a transfer of ownership. The three objectives that would be important to see at the top of the list of policy objectives of the Soviet government are the following:

- (1) To make more efficient and productive use of assets.
- (2) To generate revenue to finance government spending.
- (3) To reduce the quantity of money in private hands.

Substantial care is necessary when implementing policy reform in order not to link the objectives. Any general agglomeration can inevitably constrain the pace of achieving different and individual goals. Both quantitative and qualitative measures are required when attempting to reach an appropriate solution.

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\*Comments made by Benjamin Friedman (USA), Kimio Uno (JPN), Mario Nuti (I), William Nordhaus (USA), Alfred Kahn (USA), Janos Gacs (H), Pavel Klima (vCSFR), Karl-Ernst Schenk (FRG), Konstantin Kagalovsky (USSR), Petr Aven (IIASA/USSR) and Il Sakong (S. Korea).

The one possible way to solve existing stock and flow problems simultaneously could be by the *sale (of assets) to the public*. Initially, the private sector may not be able to absorb all assets and investment possibilities. Some measures must be taken that this situation is normalized within a short adjustment period. Basically, the private sector must buy back assets which are in governmental or state hands. The underlying objective of policy in this area is to organize, encourage and facilitate the transfer of capital assets to the private sector. The question of whether the state should actually be compensated for capital turned over to the citizens, to whom it theoretically belonged previously, arises as a rather contentious issue. In general, a transfer of financial resources back to the state is not necessary because the governing body was just holding these resources for the private sector anyway.

Once privatization of state holdings has been agreed on as a policy move, decision-makers are preoccupied with choosing the optimal form of ownership which they plan to promote. There are four main models of firm ownership that are presently most popular in the discussion. First, leveraged buy-outs, where the owners are simultaneously the managers and vice versa, although this does not necessarily have to be the case. Second, the transfer of ownership to the workers. The Yugoslavian experience resembles this second point to the extent that the management rights and responsibilities are in the hands of the workers' councils, though actual ownership has remained in government hands. Third, a broad dispersion of ownership assets or shares among the general citizenry and to then allow the opportunity for trading. Fourth, an entrepreneur system in which the dominant shareholder, who has a position equivalent to that of an owner, acts as an entrepreneur. In the latter case, the state need not be the entrepreneur, but the new entity must have the incentive to act as an entrepreneur. If the state does remain as the owner, its ownership rights cannot differ from those of the private companies. A probability of a loss of economies of scale would certainly be outweighed by new and improved competition and the finding of entrepreneurs.

Overall, the discussion of privatization in the Soviet papers seems to concentrate on the production sector. A decision has to be made or a compromise reached with respect to the proportion of private ownership relative to public ownership. In addition, the sectors (manufacturing, services, etc.) in which the implementation of such policy measures can achieve the most effective beneficial results in the shortest time need to be identified. Substantial public sectors are known to exist even in many successful market economies of today. It would, of course, be ideal to have a well-functioning

and integrated mixture of both private and public sectors to drive the growth process of an economy. The role of the government must be clear and distinct as either an entrepreneur or as a taxpayer in each particular case.

The ownership concept affects a number of other aspects essential to a competitive economy. An inadequate ownership structure leads to an inappropriate distribution of profits which itself influences the movement of savings back into productive investment. The risks associated with this decision path are an important element of a normal capital market. The fundamental reason behind privatization is to initiate some of the characteristics of a market system. The creation of a higher investment demand than the available supply of savings could lead to raised interest rates and/or capital rationing. In the Soviet case there is a definite need for a long-term credit bank or other financial institutions. A supplementary requirement is a horizontally integrated factor market where decisions on investments are made with respect to the cost of inputs (i.e., capital, labor, etc.). As a result, these inputs should be traded in the market with as real prices as possible. Followingly, a market must exist for evaluating assets, otherwise the economy is vulnerable to insider moves which are classified as a general loss to the society as a whole.

As time goes by and political systems adapt to the forever changing demands of the people, it seems that the definition and characteristics which formerly distinguished so clearly the capitalist from the socialist countries have become increasingly fuzzy. The fact remains that socialist countries do concentrate too much on just plain production as their motor for growth, while neglecting the budget side. Moving to a complete capital market should not be at the beginning of a transition agenda from a command to a market system. The element of privatization is crucial and reasonably successful, especially where enterprises rely on a large proportion of their financing to be internal as in the United States. The encouragement of this type of financing should be seriously considered by Eastern European reformers. Successful firms have diverse ownership characteristics, such as:

- (1) an entrepreneurial group (management)
- (2) incentives
- (3) competition

Care must be taken to control the enthusiasm to achieve a market full of straight-forward, text-book Western type firms.

Aside from the fact that privatization of state enterprises and assets has been proven to lead to a more competitive environment and increases in

the rate of technological change, a variety of problems still remain to be solved. The most important question to be faced is not only concerned with the choice of which route to privatization should be chosen, but also with what timing this process should proceed. If there is a lack of infrastructure and programs of labor reallocation and retraining, privatization can cause unemployment. Decision-makers will also have to deal with the problem of the many enterprises that are destined for bankruptcy under privatization due to the decades of non-competitive and not demand or cost oriented production and the heavy reliance on government subsidies. Who actually sells to whom and who will and can afford to be the majority shareholders are further unresolved areas. Finally, any move to privatization must be socially acceptable. Therefore, reformers need to adjust their policies in a way to ensure public acceptance, while still achieving predetermined economic goals and largely preventing any negative externalities that threaten to arise.

There are various ways in which privatization affects the performance of enterprises individually and thus also the market as a whole. The primary achievement is an increase in the efficiency caused by the changes in the control mechanisms. A initial step in the right direction would be to eliminate ex-ante controls and increase ex-post evaluation. As a result firms would be accountable to the public and the supply, the quality of products and demand-oriented production would improve. The importance for performance evaluation is essential to the market system. After a proper appraisal of assets it may be found that a partial privatization could be sufficient, allowing a mutual symbiosis between private and public sectors as alluded to earlier.

**Part III**

**Labor Market and  
Employment**





# Employment and Labor Market Change

*V.I. Scherbakov and A.N. Shokhin*

A developed labor market and full and productive employment are among the most difficult targets of the economic reform now under way in the USSR. It stems from the fact that the processes related to employment have not only economic but also social and even political aspects.

## Section I

Until recently the situation with employment and labor market in the USSR was characterized by the following elements:

- (1) Overemployment resulting from excessive demand for labor on the part of enterprises and low levels of utilization of labor potential (by various estimates latent unemployment in the active production industries reaches 10 to 25 percent of the total work force).
- (2) Shortage of manpower in some professions, substantial number of vacancies (around 3 million in the economy as a whole, of which 1 million in the industrial sector). Lack of educational and vocational qualification as well as of professional mobility required for the adaptation to the everchanging production environment.
- (3) Low work ethic and poor quality of labor resources resulting from the high ratio of unskilled labor (up to 25 million people), low cost of labor and its insufficient differentiation depending on workers' qualification and efficiency factors (in 1989, for example, loss of labor time in the industrial sector and construction business exceeded 40 million work-days which is

equivalent to 140,000 people not reporting for work throughout the year, causing 4 billion roubles in losses).

- (4) Distinctly regional nature of employment problems: existence of areas of labor shortages (non-black-soil part of the RSFSR, Siberia and others), and of areas with excessive labor supply (Central Asia and Azerbaijan, Moldavia). (Regional unemployment estimated at 5–6 million people result from insufficient labor and social activity of the rapidly growing indigenous population, and low level of its participation in the labor reproduction mechanisms and labor market on the one hand, and inefficient investment policy, location of industries and their structure on the other hand.) Concentration of population in large cities and industrial centers (resulting from uneven development of the social infrastructure and from the policy of centralized distribution of investments and consumer resources), exodus from rural areas and small towns.
- (5) Rigid regulation of labor (still largely practiced) which has to do with the forced labor in some areas of activities defined by law. Limited labor mobility resulting from housing difficulties as well as from the administrative system of residence permits.
- (6) Functioning of the shadow labor market: high ratio of functional changes of jobs (the so-called turnover rate reaches 15 percent and as a result up to 1 million people on the average is out of work throughout any one year), which in the conditions of labor shortages and excessive employment leads to unduly inflated cost of labor and poor work ethic; proliferation of unregistered forms of labor activity such as unaccounted overtime, growth of private activities, development of shadow economy and so on.
- (7) Shifting responsibility for ensuring full employment towards enterprises, weakness of the public job placement and employment system, an ideological approach to the employment problems (the thesis according to which unemployment and socialism are incompatible leads in practice to a situation where the country is not prepared to face temporary unemployment resulting from innovations and structural changes).

The radical economic reform and the programs aimed at improving the economic situation in the Soviet Union introduce a number of new elements into the employment equation. These elements include:

- Coming into existence of the entrepreneurial sectors in the economy (new forms of cooperatives, self-employed businesses, leased and share-holding enterprises and joint ventures), which leads to re-distribution of labor

resources (as of 1989 about 5 million people were employed in the individual and cooperative businesses).

- Drastic structural shifts in the economy, changes in the investment policies, streamlining of production through the implementation of the new economic mechanism, resulting in a massive release of workers. (Over the 9 months of the last year 4.4 million people contacted government-run job placement agencies. 2.3 million people have been helped by these job placement agencies.) Of all those who went to job placement agencies 1.9 million people or 43 percent did not take advantage of their services. It is estimated, that in 1990 unemployment may reach 1.5 million people. During the 13th five-year plan as a result of growth of leased and share-holding enterprises another 2 million workers may be released from the economy.
- New forms of interaction between subjects of social and labor relations (independent labor movement, strikes, new roles for labor unions) in the conditions where a normal “tripartite” system has not yet come into its own (workers, trade unions – entrepreneurs – government and state bodies).
- Increased demand for jobs as a result of growing inflation (need for additional income); need to provide employment for new categories of population (refugees).
- Additional difficulties experienced by youth, women with children, handicapped, and people in pre-retirement age in finding jobs in the public sector as a result of growing competition with other sectors of the economy.

Persistence of long-standing employment problems and the new phenomena in the labor market make it imperative to work out a new model of employment and an effective policy for its implementation.

## Section II

Objectives to be achieved in the field of employment are universal and can be reached through the application of the following principles:

- *full employment* where all those who want a job can find it;
- *productive (effective) employment* meaning full use of the labor and productive potential;
- *free choice of employment* which means that workers are free to decide where to work, if at all.

Implementation of these objectives in the USSR is complicated by the above mentioned employment and labor market crises. The situation is further complicated by the fact that the economic system itself is in the process of development.

There are at least two cardinaly different versions of the economic reform. Employment policy is shaped by the general orientation of the reform. As of this writing preference is given to the scaled-down version which, if implemented, is likely to emasculate the reform itself since this version will stress (especially in its initial stages) administrative methods. In the field of employment this version will be implemented through administrative means and economic sanctions aimed at regulating work force migration between economic sectors, the scale of layoffs as well as emphasis on organizational and structural methods of solving the employment problem.

The radical scenario as opposed to the scaled-down version may lead to a conflict and explosive snowballing socio-political tensions and collisions rather than to stagnation. However, given broad social support for the management structures behind the reform, legitimacy of power, immediate economic benefits of the reform (availability of consumer goods on the market, etc.) this radical scenario may promote earlier solution of socio-economic issues compared to what can be expected from the scaled-down version. This is why preference has been given to the radical scenario. (Naturally, this version will involve detailed study of how to implement the changes to minimize its socio-political cost.)

Main elements of the new employment model are, to a certain extent, identical in both versions of the reform (the two versions putting different pressure on the employment and setting the pace at which the labor market is created). These elements include:

- a. setting up of an economic mechanism offering the enterprises the necessary incentives to use rationally its labor force and become a full-fledged participant in the labor market;
- b. creation of a public job placement system (to replace the spontaneous mechanism of frictional work force migration), which would act as a go-between for participants in the labor market (labor exchanges);
- c. setting up of a compensatory mechanism to minimize the consequences of structural unemployment. The most important of these mechanisms being job retraining programs (it is also important to develop educational and qualificational capabilities forming a new basis level of knowledge);

- d. elimination of cyclic employment fluctuations through special state programs including public works;
- e. developing differentiated mechanisms to control regional labor market with various ethnic and national, as well as social and cultural peculiarities (creating new job opportunities, developing alternative employment, population policies, etc.);
- f. setting up of a system of compulsory and voluntary unemployment insurance to pay to the workers made redundant their average wages for a period to be determined by the potential of the insurance system;
- g. setting up of a system of social assistance to the unemployed in the form of unemployment benefits. These benefits payable in addition to the material support for the disadvantaged segments of population should be extended to cover the unemployed unable to take advantage (for objective reasons) of other systems of social support in the field of employment.
- h. managing the needs of the population in employment opportunities by way of:
  - extending the duration of general and vocational studies, duration and frequency of refresher courses and job retraining programs (cf: the duration of vocational training for a Soviet worker is three years shorter than in the United States); raising scholarships, offering long-term educational loans in order to ensure decent living standards for the students;
  - pension law reform; increasing pensions to a level at which the retiree would not require (as a rule) additional income to maintain decent living standards;
  - extending the duration of paid maternity leaves for women with children under three with a view to improving their working and family conditions;

Experts believe that these measures, if implemented, may lead to a reduction of professional activities by an estimated 10 percentage points. At the same time special measures are required to raise competitiveness of some segments of population at the labor market (prevention of unemployment among youth, occupational rehabilitation of women after long periods of professional inactivity, etc.);

- i. de-etatization of property, promoting entrepreneurial sectors of economy making it possible to introduce employment security mechanism for specific segments of population;

- j. legislative steps to regulate employment and labor market (it is expected to adopt employment act and to streamline labor legislation as early as 1991), enforcing contractual regulation of social and labor relations.

Several concepts related to different scenarios of economic reform were raised in the discussions of various mechanisms designed to resolve the main problems involved in shaping a new employment model.

The first concept is the concept of "shock therapy" in the field of employment involving the introduction of unemployment in order to provide work incentives and promote the formation of labor market.

The second concept is based on the assumption that unemployment in a socialist society may result only from planning and management mistakes and is not related to structural and technological changes (this assumption is supported by the fact that overemployment, labor force shortages and unemployment in overpopulated regions may exist simultaneously). Therefore a more rational centralized policy can solve the problem of employment.

Unemployment should not be regarded as a special means for promoting labor motivation. It is equally erroneous to believe that a radical economic reform, accelerated structural adjustment of the economy, and the introduction of high technologies can help to avoid large-scale regroupings of labor force in relatively short period of time. All this manpower migrations and changes of job cannot be accounted for and implemented on a centralized basis, and should be governed by labor market institutes and mechanisms. Any modern state (especially the USSR, with rich traditions of social equality and social security) should minimize the social cost of labor market operation. This is why employment policy and state programs are being worked out. They are designed to prevent massive forced unemployment, to minimize the number of people living on unemployment benefits and to create effective mechanisms to help the population adapt to the supply and demand fluctuations on the labor market. At the same time social support measures should not impede early formation of the labor market. Work on the new models of labor market and employment policy in the USSR is at its initial stage. Many parameters have not yet been defined. Thus, there are no reliable estimates as to the number of workers to be laid off (especially for different industries and professional and occupational categories), criteria have not been defined to draw a line between voluntary and forced unemployment, still to be determined are the financial implications of the lay off and social support mechanisms for the state budget and incomes of the enterprises and population.

However, the complexity of these problems makes their early resolution imperative. Any procrastination may complicate the situation at the labor market, largely increasing the costs (financial, economic, social and political) of its normalization.





# Comments on the Paper by V.A. Scherbakov and A.N. Shokhin

*Albert Rees*

Princeton University

The first section of this paper summarizes the severe imbalances that have developed in the allocation of labor in the Soviet Union. These include the hoarding of unproductive labor by industrial enterprises, shortages of manpower in some professions, and very serious regional imbalances that take the form of massive unemployment in regions of rapid population growth, especially Central Asia and Azerbaijan. The hoarding of labor in industrial enterprises is in part a consequence of placing the responsibility for full employment on the enterprises, which I take to mean that an enterprise that does not need a worker in one function is obliged to find him a position in another.

The rest of the paper deals with the goal of creating a free and efficient market for labor more like those of Western economies and with the methods for achieving this goal. In general, I believe that both the goals and methods set forth in the paper are sound, but I should like to comment on some of the methods.

The authors argue that shifting the responsibility for full employment from the enterprise to the government requires the development of programs of job training, labor exchanges, and unemployment insurance. American economists would certainly agree. In designing an unemployment insurance system, important choices have to be made about the level and duration of benefits. If benefits are too low, the unemployed will suffer hardship; if

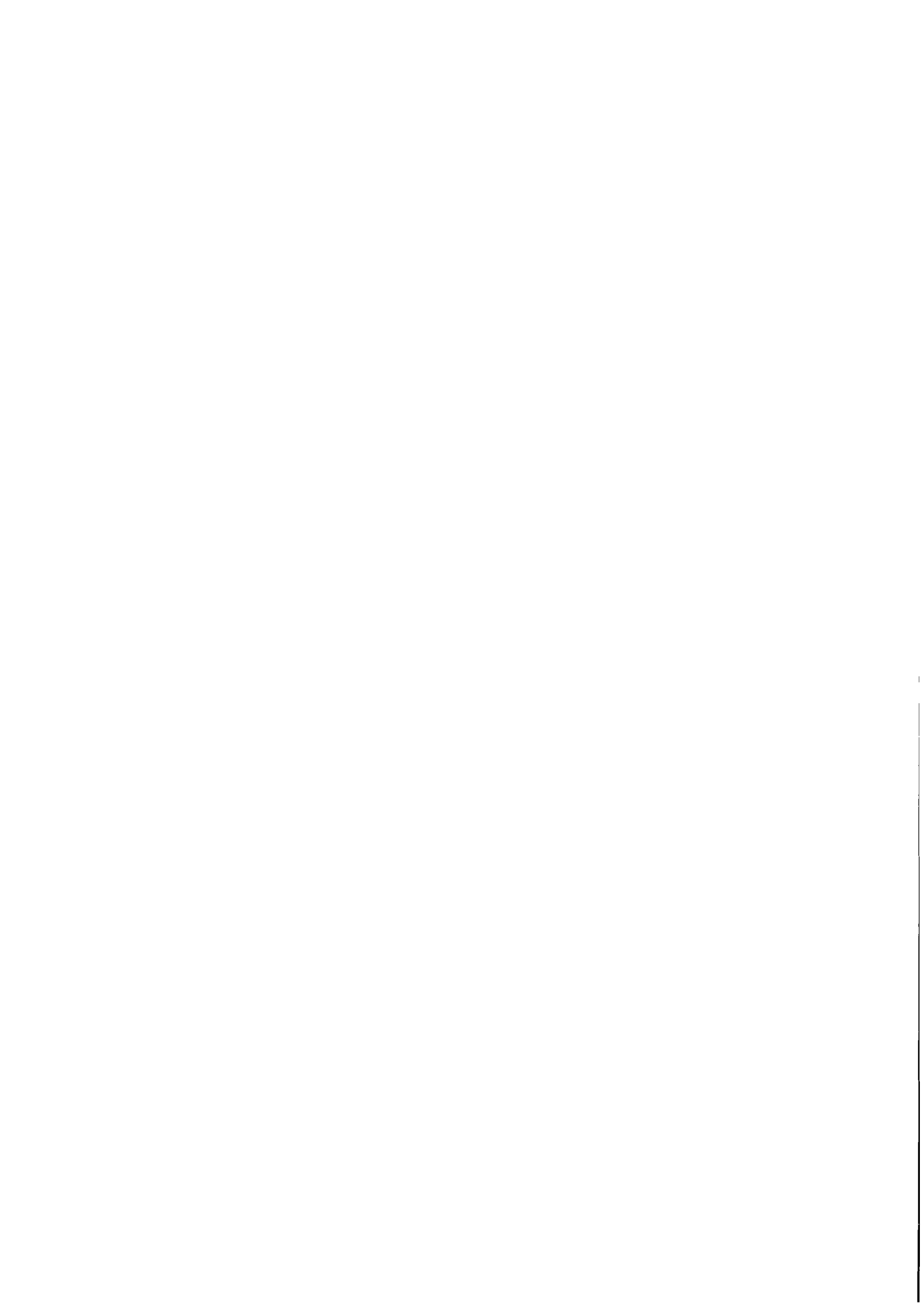
the benefits are too high or last too long the incentive to find new work will be weakened. In the United States, unemployment insurance benefits are generally limited to 26 weeks. In many European countries, they last indefinitely, which may contribute to the high unemployment rates observed in Western Europe in recent years.

In the area of public job training programs and labor exchanges, Sweden is a better model to study than the United States. American public programs in these areas have not been conspicuously successful. The state employment services in the United States place fewer than 10 percent of all workers who find new jobs, and these are concentrated in the lowest paid, lowest skilled occupations. Placements in higher skilled jobs are more often made through personal contacts, newspaper advertisements, or private (profit making) employment agencies. The idea of a private employment agency may be a radical one for a Socialist economy to consider, but they do have some advantages. In the United States, employees of the state employment services are paid a salary, while those at private agencies receive a commission for each placement, which rewards effectiveness in making placements.

Many American enterprises have had to reduce the size of their work forces substantially in recent years because of competition from imports and other changes in markets. Some of these enterprises, such as the Ford Motor Company and the American Telephone and Telegraph Company, have in cooperation with their labor unions developed successful systems of job training for employees who have been let go. These involve counseling about the kind of new career the employee would prefer, followed by supported training for this new career. The training usually takes place in a trade school or a community college, not in the enterprise that sponsors it.

One element of the proposed new Soviet employment model is "elimination of cyclic employment fluctuations through special state programs including public works." This is somewhat surprising, since it is not yet known whether a reformed Soviet economy would be subject to cyclical fluctuations. In the United States, countercyclical public works programs are not used, and no longer even discussed. The main reason is that public works take too long to complete to coincide with a cyclical downturn. Even if they are not fully planned in advance, the completion period may last into the following cyclical expansion, when they might contribute to labor shortages. The most recent countercyclical job creation programs in the United States, during the Carter administration, focussed on creating jobs in service industries, where employment can be increased and decreased quickly.

One problem not discussed in the papers is the relation between the labor market and the housing market. It is my understanding that housing is very scarce in the Soviet Union, with long waiting periods for flats, and that much housing is controlled by enterprises. Workers will understandably be reluctant to leave an enterprise for work elsewhere if this would involve giving up the right to adequate housing. It may well be the case that in order to create a free and efficient market for labor in the Soviet Union, it will be necessary to create a free market for housing as well.



# Summary of Discussions\*

*C.M. Schneider*

The detailed description of unemployment and the labor market in the Soviet Union reveals that this nation is suffering from both surpluses and shortages of labor. In simple words a solution to this dilemma calls for the reallocation of labor from the areas where it is in surplus to those where a shortage exists. Doubtless to say, that this is, as usual, more easily said than done. The reasons abound for these disequilibrium situations in the labor market of a command economy; the most common being of a geographical nature or the problem of labor hoarding by enterprises.

In a changing world striving to keep up with technical progress, the Soviet Union is an example of a nation which still has a concentration of employment in the traditional sectors, while other sectors (the tertiary sector for example) lag far behind the penetration and development they achieved in most Western countries. The Soviet labor scene is characterized by high employment, even overemployment, in agriculture, manufacturing and transportation, while employment in the service sector remains low. This is exactly the opposite of the picture in the United States and other Western industrialized countries, where experience shows that a large and a strongly manned service sector is required to improve the standard of living. Generally, the goal of full employment (or, at least, the maintenance of a consistent level of employment) is achieved with macro-economic policies. In the Soviet case, successfully attaining this target depends on decisions made by the individual firms, or in other words, at the micro-level. The actual line of command for policy decisions is not quite so clear because a majority of enterprises were and still are in state hands.

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\*Comments made by Albert Rees (USA), Wil Albeda (NL), Ognyan Panov (BG), Benjamin Friedman (USA), Richard Cooper (USA), Merton J. Peck (USA), Soren Wibe (S), E. Yasin (USSR), Leonid Grigoriev (USSR), A. Chubais (USSR) and Kimio Uno (JPN).

The major obstacle hindering the development of a functional labor market in the USSR is the lack of labor mobility. The following are a few suggestions that could lead to possible solutions to the problem of creating labor mobility:

- (1) *Unemployment Insurance (UI)*. UI is a definite requirement in a free labor market environment. It would be more appropriate to make the management and distribution of such benefits the responsibility of regions or republics rather than of the central government. Careful consideration has to be given to the level and duration because overly generous unemployment benefits will be a disincentive for people to seek employment.
- (2) *Employment Exchanges*. The situation with respect to blue and white collar placement operations must be improved or even developed in many areas. In addition to state placement offices private employment agencies should be established where a fee might be charged to the employer. As a result, unemployed workers and the number and type of vacancies can be monitored and matched to facilitate a more desirable employment picture. The agencies could advertise positions as well as people seeking work.
- (3) *Retraining*. The opening of borders and the increase in foreign trade will inevitably lead to higher imports that often have the effect of raising unemployment. The surplus of workers will need retraining programs supported by enterprises and the unions to allow the displaced labor to be reintegrated into the labor force. If private companies take over the responsibility of retraining, their obligation will no longer be to just employ and re-employ depending on swings in the economy, but to retain a flexible work force which will prove better for the firms, the employees and society as a whole. Both in the training and retraining phase, the costs should be shared between companies and government. Thus, quality and demand responsive training can be ensured.
- (4) *Counter-cyclical Activities*. If public works did not take too long to get underway and attempted to engage in counter-cyclical activities, some of the employment slack created by the economy could be taken up. These measures will generally only work in an active economy and not with big projects where the lags may actually lead to overemployment in certain periods.

In general, two items are paramount to the development and activity of a free labor market. They are:

- (1) *Freedom to Move.* Unfortunately, this is hardly possible in a society that utilizes control instruments such as resident permits and the like.
- (2) *Availability of Housing.* In the past, Soviet enterprises largely controlled the amount of housing stock; so, a worker was afraid of losing his home if he left the company. Therefore, it is clear that a free housing market is necessary. A problem arises when the new prices that reflect actual supply and demand situations on the housing market will be too high for the average person to afford. The threat exists that citizens may interpret this as a breach of the social contract. The housing must not only be available, but the conditions of the dwellings must meet some acceptable quality standard.

The key to a functional labor market is the free flow of people. Employees should not have to live with the fear of possibly experiencing social losses as a result of movement.

Eastern European countries face an overwhelming range of problems with respect to labor and unemployment. The much cited surpluses and shortages are the result of a lack of adequate training for job flexibility, the strict government regulations concerning translocation and the lack of a tradeable housing stock (other than on the black market where there are only opportunities for the select few with sufficient means), which all negatively influence the essential mobility factor. During the reform or transition phase it would appear appropriate to have the state managing the labor market. A clear system of job classification is required in order to ensure equal remuneration for jobs of equal value. Reforming centrally planned economies should attempt to adhere to a transition policy where real wages do not initially increase so that enterprises have time to develop, to reinvest profits and to allow the development of "true" trade unions. Well-trained workers, entrepreneurial employees, market oriented managers and educated trade union leaders are all crucial elements required if the entire labor market system is to work.

There is no doubt that a new process of progress has been embarked upon, with which a certain loss of security (that was considered to be at the very foundation of a real socialist system) is associated. Once again, social acceptance of any alterations in the existing labor organization are main points of discussion. The labor market is the most developed relative to the others (such as commodity, capital, etc.) in the Soviet Union. In order to stimulate productivity and the working environment, labor must be treated as a team or group and always as a system. Problems arise with individualization. Labor market reformers must prepare for the redistribution of the labor force

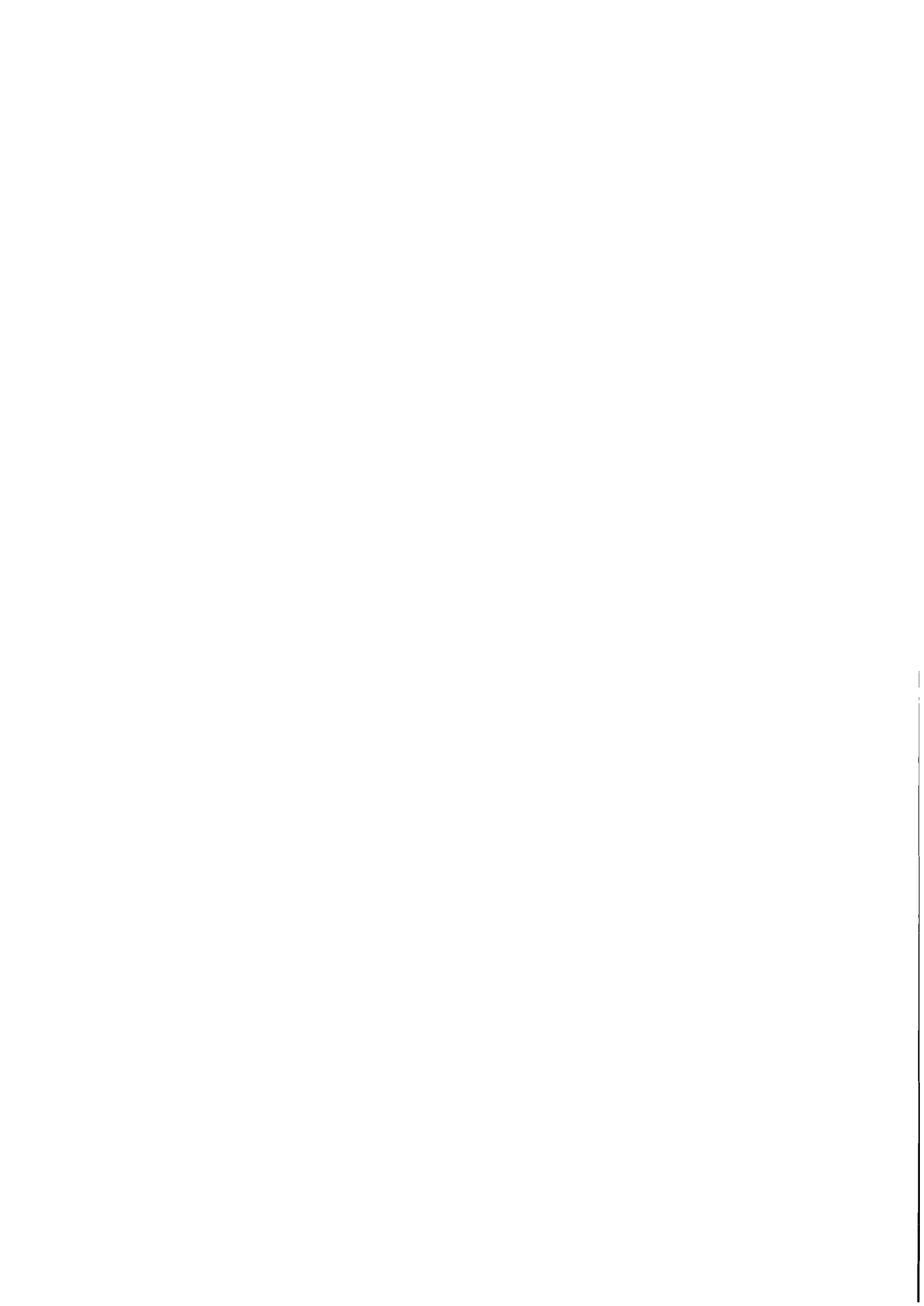
between the state and non-state sector. In lieu of the new situations facing the labor market, it becomes quite evident that trade unions should play an essential role. They are present to ensure harmony within the enterprise, to influence managerial efficiency, to protect workers from malicious managerial acts and to influence the wage levels.

The new development process needs to be supported by accompanying measures in other areas of the economy. In this sense there are a few additional comments to be made on the activation of a free housing market. The liberalization of housing is linked to the general privatization of other assets. The value of the housing assets are probably much higher than the other asset stock in the economy. Of course, there is always the alternative available to legalize the black market in housing. This might even be possible engaging in incremental changes so as not to cause too large a disturbance in the system as a whole.



## Part IV

# Opening of the Economy



# An Open Economy: The Soviet Model

*I. Ivanov*

In the contemporary interdependent world the USSR is an integral part of the global marketplace. Therefore, the country has to be managed as such and the Soviet leadership does pursue in transforming our economy into an open one, progressing in an interaction and in competition with the outside world.

This goal may seem overambitious for a country, having 6 percent export quota in its national income only. Nevertheless, the movement towards an openness is now under way and represents an important feature of the perestroika as a whole.

Being unprecedented for a planned economy this model is challenging enough in both academic and business dimensions. Not all answers are ready yet or publicly acknowledged. Thus this forum may be instrumental in inviting the outside reaction on the concept and measures concerned, summarized below.

## Some Fundamentals

According to the foreign economic strategy, adopted by the Soviet Communist party and the government in October 1988, the foreign trade turnover of the USSR till the years 2000–2005 is expected to grow 1.2–1.3 times faster than national income. This is a tangible manifestation of our world oriented intentions. However, the most radical innovations in this domain are mainly qualitative ones and rooted in a fundamentally new approach to the very role of foreign economic relations in the development of the Soviet economy.

The architects of that approach argue that these relations have to be used not as “shortage-bridging” instruments of an *ad hoc* nature but through a proper market specialization and the positive terms of trade, as an instrument to gain an additional increment in the Soviet national income over and above its domestic formation. Equally in the long run foreign economic relations are expected to contribute to modernizing the Soviet economy and the management technique. To this end the country is ready to assume some calculated risk and to expose by a degree its domestic economy to a profound influence from the world marketplace.

Accordingly it is understood nowadays that:

A. On macroeconomic level

- The Soviet technological, structural and investment policies ought to be oriented not to the domestic (whatever improved), but to the world standards only.
- The Soviet market ought to be accessible for foreign competition with a view of an equalization of the domestic and foreign production costs and a better distribution of the productive factors.
- A pricesetting reform ought to narrow the gap between the domestic and world market prices, the justified and transparent link between them will be thus played by the new custom tariff, tailored by international standards.
- The exports and imports have to play alternatives against the domestic investment and production decisions.
- A shift in the foreign trade planning is essential from “shortage-bridging” to comparative production costs approach.
- “An openness” has to engulf all regions of the USSR.

B. On the level of foreign economic relations as a whole

- In addition to products, which are domestically physically unavailable or in short supply, the imports are expected to replace the nonefficient local production, to modernize industrial and social facilities, to enrich the consumer supply and to play the instrument of regional development.
- In addition to gaining foreign currency the exports are expected to set a yardstick to measure the quality of domestic products, to support the Soviet investment abroad, to ensure the economy of scale and to contribute to regional development.

- All types of the legitimate business transactions will be open for the Soviet business entities, including trade, industrial cooperation, investments, leasing, consulting, credits, stock operations, commodity exchanges, money market etc.
- The Soviet business and foreign trade legislation ought to be comparable with internationally acknowledged norms and standards and on that basis the USSR shall cooperate closely with international economic organizations and renovate its commercial treaty network.

#### C. On the enterprise level

- All interested enterprises will be allowed to transact internationally.
- A part of these export proceeds (after taxes) will be reserved to the enterprises.
- The business unions and associations will be formed particularly with the aim to lobby the authorities concerned on the matters of common interests.
- The enterprise may mobilize currency through loans, currency auctions, securities, etc.

With the decentralization in decision-making, conceptual and legal restructuring, described above, the USSR cannot be treated any more as “state-trade country” in the old, segregative sense of this definition. Ultimately, one may expect to see the Soviet territory as a part of the world marketplace.

## Sectoral Developments and Innovations

The aforementioned is not merely a philosophy. The developments and innovations concerned are under implementation step by step in all sectors, related to foreign economic transactions. *Planning* is no more detailed commodity/country matrix. The plan contains aggregate value indicators for exports for the ministries (republics, business associations) concerned, which are free to choose the specific products and countries to sell. The imports are specified for national programs only. The rest of foreign currency is either allocated as bonuses for exporters or distributed among them on a commercial basis (loans, auctions, etc.). Therefore the plan now looks like a balance of payments, divided into three currency zones: transferable rubles, clearings and free currencies settlements. Within the last part no

country-by-country allocation is practiced and the actual imports are determined on the competitive basis.

### *Exchanges Rate and the Ruble Convertibility*

The present official exchange rate of ruble to foreign currencies looks artificial and inappropriate for business use. The new economically justified rate is under calculation. It will be based on the relative purchasing power of the Soviet and foreign "basket" of products traded and introduced after the price-setting reform in the USSR.

The new rate is expected to provide an objective yardstick to measure the final effect of the trade exchange on both macroeconomic and individual transaction levels. Reportedly, it will be lower than recently. It also implies that at least a part of current Soviet exports will become then nonprofitable and imports more expensive in domestic prices. However, these risks are unavoidable and calculated.

As to convertibility, despite some radical voices, it is a rather distant goal and in the majority view may represent by itself rather the *result* of the profound modification within the Soviet economy than an *instrument* for these modifications. At latter, a "big bang" approach in the USSR is nowadays socially unaffordable. Therefore, the experts see at least four stages (pre-requisites) for a meaningful convertibility such as:

- A stabilization of domestic financial system, especially state finance, because the ruble cannot be stronger abroad than within the country.
- A professionally made price setting reform, narrowing the gap between domestic and world market prices, is needed to determine factual purchasing power and thus a new exchange rate for the ruble.
- A more or less developed internal market in the USSR with the wholesale trade as the dominating channel for domestic business turnover (so-called "internal convertibility").
- A strong competitive export sector to support the ruble on international money markets.

All in all, these prerequisites may be ensured not earlier than the year 2000. Nevertheless some practical partial or limited version of the convertibility can be imagined in the meanwhile with the priority to profit remittance on foreign investment.

The specialists recommend to start the convertibility for the current account transactions first with postponing the goal to make the ruble an international reserve currency for the latter stages.

### *Investment*

The business in the USSR is growing beyond the traditional trade. More than that, the government intentionally promotes various types of international production, structural adjustments in the Soviet economy towards its interdependence with the world market.

As a result the special investment program to strengthen and to industrialize the Soviet export sector is planned for 1991–1995. Foreign investments in the USSR are legalized and the Soviet enterprises are also entitled now to invest abroad in marketing, production lines and securities. As of February 1, 1990 about 1500 jv with foreign participation were registered in the USSR with total authorized capital of about 5 billion US dollars, including 250 in operation with total production volume in 1990 of about 1 billion US dollars, divided by 9:1 for domestic market and exports. There are also about 150 mixed companies with Soviet participation abroad. There are also mainly marketing networks (selling, as an example, 50-100 percent of the Soviet machinery in some Western European countries), but will be supplemented by production and mining units soon, particularly in the framework of debt-to-investment swops in developing countries.

### *Labor and Capital Flows*

The Soviet view of the socialist market is a complex one and covers not merely goods but also services, capital and eventually labor force. As to capital the foreigners are entitled to have deposits in the Soviet banks, to take part in currency auctions, credit syndications, to operate on the Soviet commodities and stock exchanges.

Foreign labor is already in use (more than 120 thousand persons in 1989) in the USSR from Eastern Europe, Finland, Turkey, China, Cuba, N. Korea, India, and Syria. On a regulated basis, this practice will continue alongside with an innovative draft legislation, allowing the Soviet white and blue collars to get temporary jobs abroad, now under scrutiny in the Supreme Soviet.

*Regional Policy*

On the basis of perestroika a new shape of the Soviet federation is emerging. Some constituent republics (regions) either have already gained "economic homerule" (Bielorussia, Baltic Republics), or pretend to map it up soon (Moldavia, Kazahstan, Russia), this process does *inter alia* facilitate the exposure of their economies to international market, particularly by its decentralization of the decision-making and the setting up of the local infrastructure to transact internationally (local middleman organizations, chambers of commerce, etc). Some regions, mainly remote, are entitled for the general preferential foreign trade regulation (Far East, Kola Peninsula).

At the same time the prevailing mood is that the decentralization concerned has to have its regional limitations and not to fragment the single Soviet market and custom territory or deteriorate the state foreign economic policy and regulations. The latter have to be kept intact as the federal (centralized) functions exclusively, thus corroborating the Soviet commitments before the trading partners.

*The Council of Mutual Economic Assistance*

For the last 40 years the CMEA was the major sphere for an internationalization of the Soviet economy with the most far-reaching instruments and arrangements to pursue it. The CMEA share in the Soviet foreign trade turnover was around 60 percent and real structural adjustments to the Soviet socialist economic integration are already the fact of life in the USSR.

However, this integration had progressed mainly on the intergovernmental level, through the regular coordination of the national plans. On the business level it was rather weak and sporadic. This scheme of the integration proved itself as a noncomplex one and is challenged now by the internal market oriented reforms in Eastern Europe. The Soviet specialists also believe that such regionally limited openness is not a model to run a large-scale economy as ours in the interdependent world and thus ought to be viewed in a broader framework.

Up to February 1990 no member country claims to disband the CMEA, arguing instead for its profound market-oriented restructuring. The Soviet Union persists in particular in denominating its commodity exchange with CMEA partners in free currency and world market prices. The next round of the intra-CMEA talks on the matter is expected in May-June 1990.



### *The Frontier and Coastal Trade*

With the decentralization in decision-making underway, this trade flow shows a particularly remarkable growth, "melting" the economic borders of the Soviet economy. This is the domain of mainly small and medium-size local businesses, enjoying the state promotion measures. The latter are a more liberal regime for barter transactions (not taxed by state) and a relatively free maturing of local resources between the domestic market and export.

This type of trade will be promoted further on, but under a rational regulation (excluding for example the interpretation of the coastal trade as overseas or even global) resembling that of the GATT.

Taking together these trends form the new atmosphere for the business cooperation with the USSR, particularly favorable for long-term projects and international production. More than that the trends concerned are now legally corroborated and facilitated by the development of the Soviet business legislation and its regulatory instruments.

### **The Legal Setting for an Openness**

Driving towards an openness the USSR does codify its horizons preferably in accordance to the international law. The major legal and regulatory blocks concerned are the following: *Basic legislation* intended to regulate in a new way the domestic economy, but applicable as well to international economic cooperation. This is for example the property law (draft) legalizing the foreign property within the USSR and protecting it on the same basis as national ones. Besides it opens the gate for new types of property as republican, collective, companies and quasi private. The law on enterprise (draft) entitles all interested business entities to transact internationally, the tax law (draft) keeps the preferential treatment for joint ventures etc.

The draft custom law and custom code, tailored in accordance with the GATT rules, custom cooperation council recommendations and the Kyoto convention, is ready to be introduced before the Soviet parliament. The antitrust legislation, the joint stock company law, new currency and banking regulation and, at last, new foreign investment law are on the agenda of the Soviet law-making bodies too.

*International Treaties Network*

The progress in the USSR integration in the world economy evidently depends on the regime for this process and the balance of the rights and obligations concerned. Equally, the previous Soviet economic diplomacy, merely bilateral, has to be transformed into a multilateral one.

To this end the network of the Soviet trade treaties is under renovation. In December 1989 the broad based trade, commercial and economic agreement (the largest ever for both parties) was signed between the USSR and the European Communities. Replacing 12 previous bilateral trade agreements (to be nullified by the EC-1992) it expands the scope of EC-USSR cooperation much wider, on about 20 sectors of production, research and services. One may note also, that the USSR for the first time in its negotiation practice accept in this agreement safeguard and price clauses in internationally standardized wording. The talks over USSR-US trade and cooperation agreement are also underway, absorbing, *inter alia*, some topics of the Uruguay Round (intellectual property, services, etc.). We are also open to negotiate with EFTA, ACEAN and Japan.

The USSR does pursue a rapprochement with GATT. The noticeable preparatory homework has been done at this end, but due to a delay in the domestic reform (prices, wholestock market, new exchange rates) the USSR is not as yet ready to apply for full membership in the agreement decided to claim in it an observer status first with the full membership in due course. Between these two steps we foresee a period of education and adjustment, when GATT expertise will be used to our foreign economic mechanism and legislation used to modernize our foreign economic mechanism and legislation. The observership application may be filed with the GATT secretariat in early March.

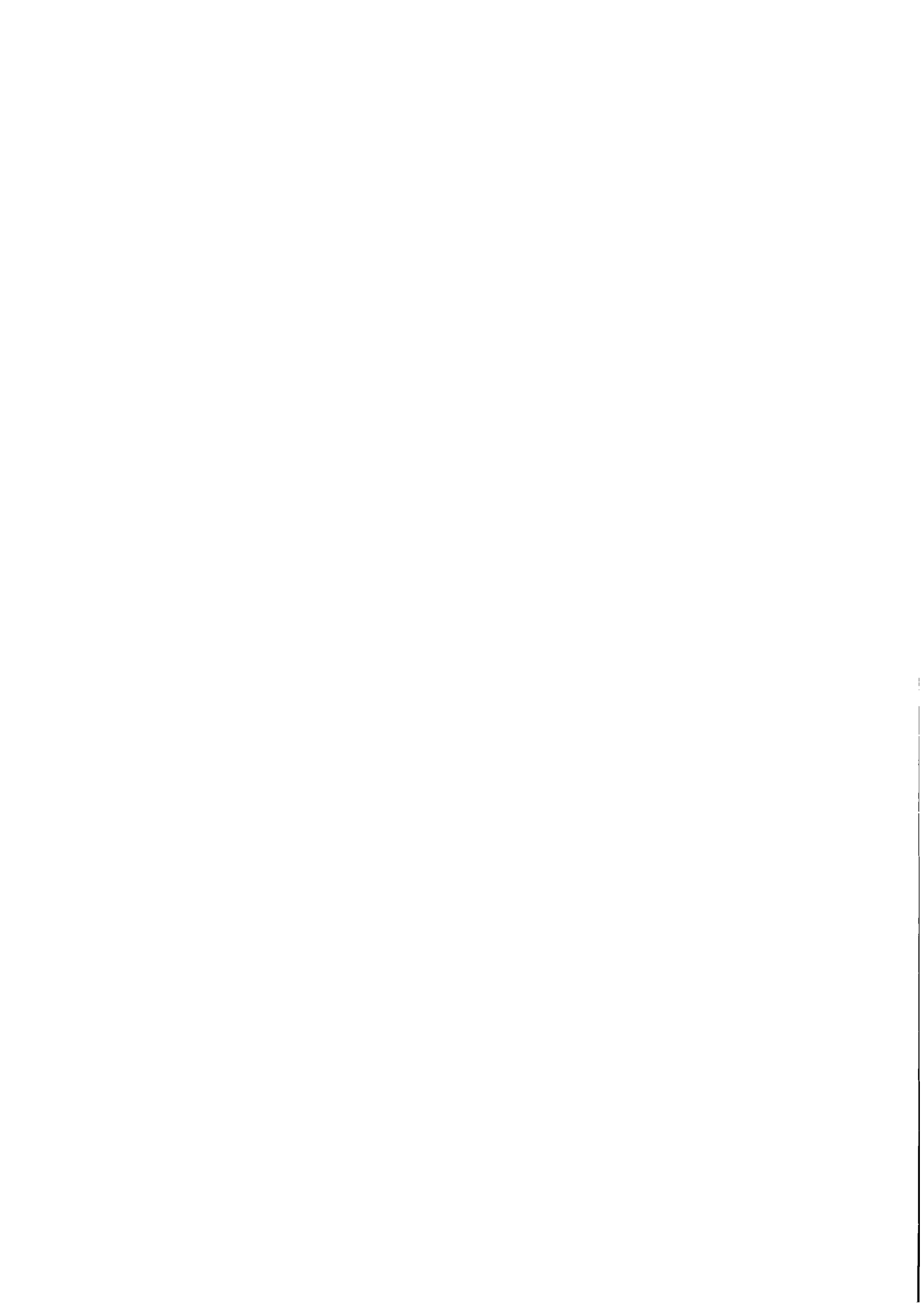
There are also some voices in favor of our entering the IMF. However, this action is questionable in many facets and need further feasibility studies.

*Trade Policy Instruments*

Their arsenal is also under renovation in accordance with international standards, namely:

- The new custom tariff is prepared on the basis of the harmonized nomenclature and in accordance with GATT rules, which will be introduced right after pricesetting reform.

- the set of non-tariff regulations is already in force since March 1989 (quotas, licenses) and if necessary may be supplemented by price control.
- The new form of custom declaration is in use since April 1989, which is the replica of EC single administrative document.
- The system of the special registration of the Soviet business entities, operating internationally is in action with 12.5 thousand entities appearing in the State Commercial Register in February 1990.
- The representative offices of the foreign companies from November 1989 are allowed to be open, in addition to capitals, throughout the USSR.
- The new non-commercial exchange rate for ruble (6.3 rubles for 1 US dollar) was announced in November 1989 for both to facilitate foreign tourism and to suppress black currency market.



# Comments on the Paper by I. Ivanov

*Urpo Kivikari*

Turku School of Economics and Business Administration

The restructuring of the Soviet economy was initiated a few years ago in the field of external relations. Now, recent developments in the USSR as well as the revolutionary events in Eastern Europe and in the East–West set-up have accentuated the need for drastic re-evaluation, re-orientation and re-organization of the Soviet participation in the international division of labor. Professor Ivanov's article gives us an analytic description of this complicated topic.

The present situation is clearly characterized by the modest export quota in the Soviet national income. This indicator will still remain low in the coming years, even if the income elasticity of imports would be somewhat over one as expected. It should also be noted that even the export ratio of the US economy, though higher than the Soviet one, is not comparable with the export intensity of smaller developed economies. But, as is well known, commodity exports from the USA are modest compared with the global production pursued by American subsidiaries abroad. Observing the Soviet model of open economy also emphasizes internationalization of production, there is good reason for bringing it up as the first point in this comment.

*1. Foreign direct investment.* Considering Soviet resources and the prevailing shortages, it is natural for the Soviet Union to internationalize its production within its own borders now and postpone investments into the outside world. Direct investments on Soviet territory, which unfortunately have been limited to joint ventures thus far, provide the Soviet economy

with capital, technology, management skills, access to western markets, etc., on favorable terms compared to alternative operations. The undisputed advantages of western investments manifest an incentive for the Soviet leadership to modify the country's economic environment more more lucrative for foreign companies, i.e., to introduce market economy. Without such developments the disappointments experienced by many Western partners in joint ventures will not pass as merely starting difficulties but will form a lasting impediment for foreign investment.

If the Soviet Union is to have a net inflow of capital in the 1990s, a considerable net outflow of labor, including permanent and temporary emigration, is expectable.

*2. Decentralization of foreign trade.* While there used to be less than a hundred Foreign Trade Organizations in a monopoly position to transact internationally, principally any enterprise or organization now may become involved in international business. Such "normalization" is required to raise the international competitiveness of Soviet production. An extended range of exportables and appropriate use of international operations can only be achieved through business contacts with international markets. State authorities, banks, and the enterprises still lack the skills needed in the new situation, yet changes in the behavior of Soviet exporters and importers can gradually be expected by western partners. The motivations and strategies of the new transactors will differ from those characteristics of the old-type FTO monopolies who controlled export and import transactions using both separate and mixed deals.

The activities of FTOs have been led by central authorities in Moscow where these companies also are located. In my opinion, the decentralization of foreign transactions will involve a more impressive rise of regionalism than was anticipated in Prof. Ivanov's article. At present there is no "single Soviet market". Nor is it possible to create an integrated Soviet market "from above" by federal laws and orders, but only by integrating regional markets of republics and smaller areas. It is obvious that the inevitable process of bringing about regional market economies will also entail a shift of responsibility for and earnings from foreign trade to these regions. This is not in contradiction with the fact that the Soviet Union as a whole should have effective tariffs against the external world, which for its part would also help break up the status of a "state-trade country". Of course, it would not

be desirable at all if separate customs territories or non-tariff barriers would appear to hamper intra-Soviet trade.

*3. Convertibility of the Rouble.* All reforms of foreign economic relations suffer seriously from the fact that the USSR is lacking SCU, "Soviet Currency Unit", money really workable in intra-Soviet exchange as well as in international market transactions. It is therefore natural that speculations about the convertibility of the Rouble be presented on various occasions. The point here is to clean one's own back-yard first, i.e., to carry out the reforms that are mentioned in the article. To fulfill all the required prerequisites of full convertibility in the entire country will take even longer than the 10 years estimated by Prof. Ivanov in his article. There is, however, nothing to prevent a partial convertibility which should be put into effect immediately. As a first step, the profits earned by western partners on their investments should be rendered convertible at once.

*4. CMEA – from aid to trade.* Practically all the foreign trade of the USSR will be based on convertible currencies after the abolishment of the transferable Rouble in intra-CMEA trade in 1991. In fact, the CMEA has ceased to exist as an organization for division of labor among the centrally planned socialist economies. Whether there will be mutual cooperation within the CMEA framework in the future or whether other organizations will be employed is yet to be seen.

A general impression observed recently is that the European members of CMEA find it frustrating to be involved in "Mutual Assistance", it appears that most of the countries regard themselves as the parties to give and not to receive. A decision has been made to adopt the principal of "Trade" from the year 1991, and – as is well known – trade only materializes when each of the parties finds it beneficial. The adoption of world market prices and convertible currencies as per the decision of the 45. Session of CMEA in Sofia, January 1990, will presumably be more problematic for other member countries of the CMEA than for the USSR whose terms of trade are expected to benefit a great deal from change. The change of the nature of CMEA trade will also support the economic reforms of the Soviet Union, as it does support the reforms of other CMEA countries, but the problem encountered is that intra-CMEA trade and unfinished projects run into the danger of collapsing during the upheavals.

5. *Friendship, not fear: EC, GATT, IMF, etc.* In summer 1989, during his visit to West Germany, President Gorbachev said it to be desirable that trade creates interdependence between the USSR and the FRG. This was an expression of a completely opposite attitude to that prevalent in the past, namely the doctrine of avoiding dependence in east-west trade. The USSR no longer considers the EC as an economic bastion of capitalism but as a builder of a Common European House. Soviet attitudes toward international organizations like GATT and IMF have also changed radically.

Both in the East and the West, in the USSR and the USA, the approaches are moving from those of rivalry and confrontation between blocks toward mutual cooperation. Naturally, this new atmosphere is decisive for the Soviet goal of becoming an integral part of the global marketplace. I fully agree with Professor Ivanov's statement that new contracts and international memberships in the first stage particularly serve educational purposes. The best way of learning business is doing together.

The key words in the perestroika of external economic relations are openness of production. But what is there behind this facade that is shown to the world outside?

For the Soviet economy to be effectively integrated with the world economy, fundamental changes are required in domestic economy. Much attention is needed to develop domestic industry and production, including development of the main source of export income, energy production. As the perestroika of external economic relations has started without corresponding reforms in other sectors of the Soviet economy, the results are seen in confusion, frustration, and even disorder. Joint ventures cannot find supply markets for procuring inputs. Organizations newly engaged in foreign trade do not possess the required skills – nor can foreign trade partners obtain the background information (e.g., on creditworthiness) needed for establishing business relationships. The banking system, business services, and the infrastructure must be renewed. Appropriate order in the Soviet House, stability in its political and economic life, is a necessary prerequisite for becoming part of the European House. This development, desirable for everybody, deserves all the support from the external world it can get – and not just passive sympathies but also concrete assistance.



# Summary of Discussions\*

*C.M. Schneider*

Today it is becoming more and more evident that there exists a general world-wide desire to open economies as a whole or at least in certain markets (i.e., the financial markets of France and Japan). Certainly, "opening of the economy" is no ambiguous concept. It basically refers to foreign capital movements, domestic capital movements, merchandise and other trade, and so on.

The question of why there is so much interest in an opening of the economy inevitably arises during the discussion of this topic. A wide variety of reasons are heralded to be at the heart of the move of a centrally planned economy to one more intensively integrated in the world market. This allows both the taking advantage of its unique talents, status and resources and the utilization of the strength and support of the group. Four of the main reasons for participating in an economic environment characterized by relaxed national frontiers are:

(1) *Resource Requirements*

A growing economy with the desire to improve production generally requires quantities and types of resources which must be imported from the rest of the world. Although this is not always necessarily a necessary feature of modernization, the goal here is to increase investment rates.

(2) *Technology, Ideas and Know-How*

Countries which have come to lag behind the rapidly advancing levels of know-how in the western industrialized nations have, therefore, difficulty to compete in the international market place. These states need

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\*Comments made by Richard Cooper (USA), Anthony Solomon (USA), Urpo Kivikari (SF), John Montias (USA), Janos Gacs (H), William Nordhaus (USA) and Alfred Kahn (USA).

to encourage the transfer of technology and management strategies that have proven to be successful in improving productivity, efficiency and competitive vigor. This utilization of indirect investment can be a very successful instrument to stimulate growth as can be seen in the examples of Japan and South Korea. Joint ventures are also examples of a combination of knowledge transfer and capital. Finally, the implementation of new technologies and strategies develop to be sources of badly needed foreign exchange.

(3) *Gains of Specialization*

An opening to the international market place motivates the utilization of domestic talents and resources. When a nation utilizes its comparative advantages, it can produce in a more cost-effective fashion and maximize profits, while simultaneously allowing the preservation of the environment and the longevity of non-renewable resources.

(4) *Competition*

Opening the economy will assure the establishment of a competitive environment. Competition and incentives are vital to drive economic growth, while improving the consumers freedom of choice which, in turn, spurs consumption that once again fuels the competitive atmosphere in a non-monopoly market. Doing away with artificial border restrictions will inevitably increase competition in the areas of prices and quality. The foreign competitors can and often will act as a motor for internal or domestic competition. Finally, comparative advantages can be exploited.

The nature and timing of a conversion from the traditional closed command economy to an open market economy are still unresolved points of discussion. An opening will in the normal sense be accompanied by the implementation of tariffs. The reforming economies should try to stay away from quotas and other quantitative restrictions that tend to impede efficiency, productivity and motivation. The timing and severity of such controls will inevitably have an impact of the functioning of the market. Consequently, it would be advisable to keep the tariff quite reasonable and apply it in a similar manner as a tax which should not only target imported, but also domestic products. Clearly, this provides the government with a relatively reliable source of revenue. Real competition will be influenced by the use of tariffs; nevertheless, this situation can present new challenges for entrepreneurs in their attempt to maximize profits under the presence of different restrictions.

During the opening of a market economy, competition and incentives play a crucial role. Import penetration definitely influences internal mar-

kets. If a price reform should take place, import competition must be provided at world prices, particularly during the early stages of adjustment. Of course, this will require the free availability of foreign exchange for imports. The question of the need for an actual market determined exchange rate is invariably linked to an opening of the economy. Experts and policy-makers are faced with the problem of choosing the initial rate. It may be appropriate to select a slightly undervalued rate which is favorable for exports and simultaneously makes imports less attractive. This is no pledge to increase protectionism, but simply to encourage domestic production for export. Eventually, the goal must be to reach world levels of quality, competition and other market characteristics. Once the situation stabilizes, it is likely that an appreciation can be expected.

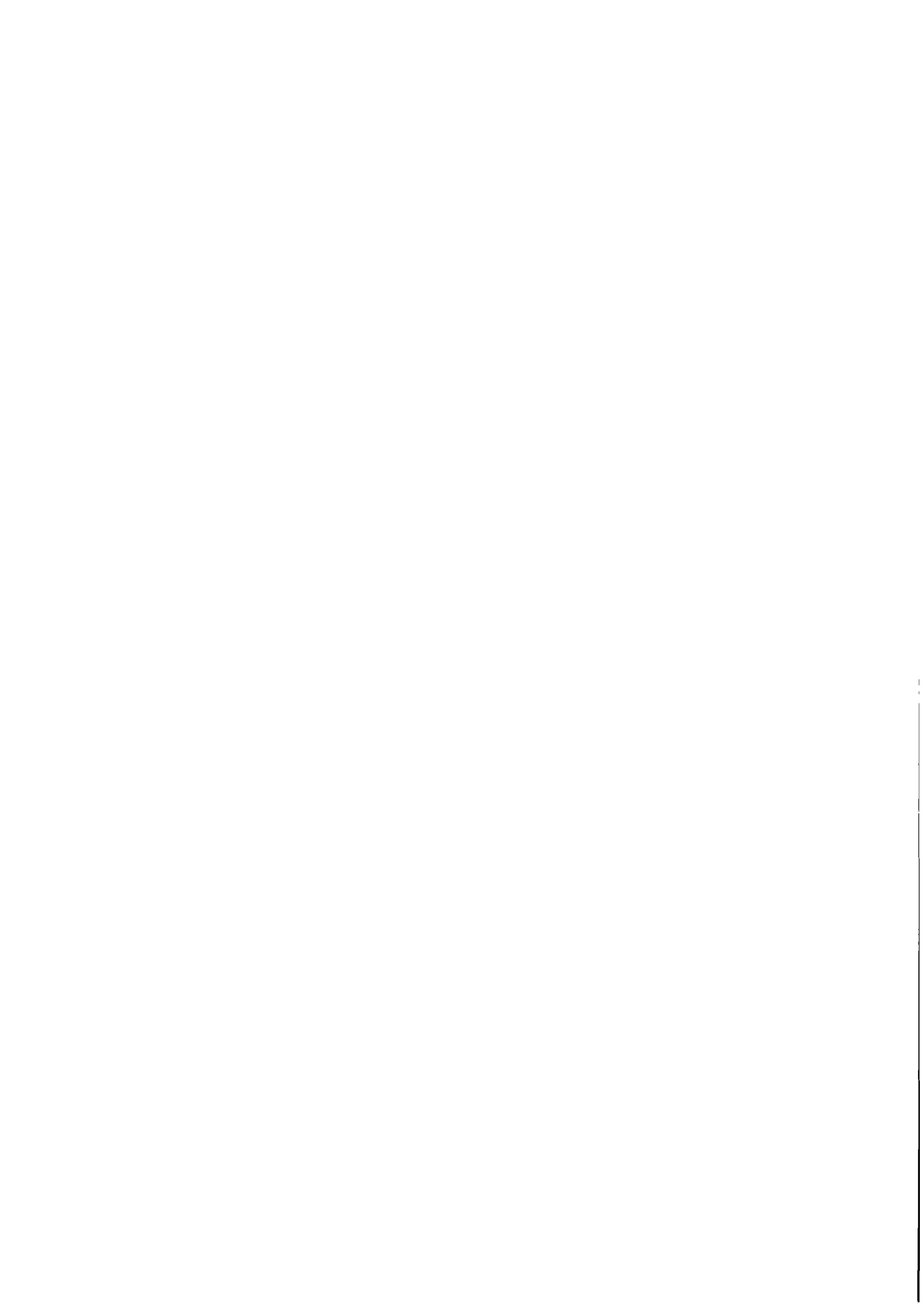
A number of elements must be in place in order to facilitate a successful opening of an economy, although no guarantees can be made in any case. One of the most important factors is macroeconomic stabilization, which includes implementation of policies to soak up excess purchasing power and to solve the current account surpluses and budget deficits. Furthermore, a price and enterprise reform must be undertaken and well under way, so that the foundations of a competitive system are in place. At the same time, firms in the Eastern European reforming economies must be assured greater and freer access to Western technology, training and information. In addition, successive steps of liberalization should involve the opening of the import system and a move toward convertibility. In simple terms this means that the "complete" openness of the economy can only be achieved within the framework of a market economy. To a large extent, the benefits of opening the economy will be influenced and to some measure predetermined as a result of the established policies within a country.

In general, the central authorities will still have to maintain certain controls during the transition phase. Especially in conjunction with attempting to attract foreign investment, the government must provide various guarantees and must ensure that profit can be remitted. There remains little doubt, that the initial step toward transformation involves the collection and analysis of sufficient macro-economic data to allow any macro-economic policy decisions. Centrally planned economies would surely profit from a membership in a number of the international organizations and funds, but they must beware not to join with too much haste because a premature membership is accompanied by numerous restrictions which may be detrimental in the long-term. Of course, joining in multi-lateral activities will help the social

and political images of socialist countries and will improve and speed up the integration of these countries into the global open market.

**Part V**

**Issues on Stabilization**



# Economic Stabilization: Monetary and Fiscal Policy

*K. Kagalovsky and A. Khandruev*

Recent years have witnessed sharp deterioration of the financial situation in the USSR. In the period from 1985 to 1990 the state budget deficit has grown five times achieving 10.7% of GNP. By the beginning of 1990 the internal state debt has grown almost four times making up 440 billion rubles or 44% of GNP. The reason for this lies in the continuation of the old financial policy under the changed conditions. As before the budget expenses grew regardless of real financial capacities of the state. Whilst from 1985 to 1988 the real budget funds (less the money attracted for debt servicing) grew by 1.7%, the expenses grew by 19%. In 1989 the USSR State Committee of Statistics gives the inflation rate at 7.5% which is a modest estimate to our mind.

In 1989 the situation began to change. If before the problems of finance were somewhat in the shadow, then now the society and the government have become gradually aware of their importance. Attempts have been made towards the so-called "fiscal sanitation". Still neither all seriousness of the situation, nor the measures taken allow to follow the rapid deterioration of the financial situation. If on one hand the awareness of the fact grows arithmetically, then on the other hand the situation itself worsens geometrically.

The political situation has also changed bringing about the politization of economic decision-making with the new Soviet parliament having a considerable influence over this process.

In the first instance it concerns the fiscal policy. The public choice in relation to the most important economic priorities and basic directions of the spendings of state resources has become institutionalized though before

it happened in a latent form. All this was reflected in the adoption of the budget law for the year 1990. This time a more serious budget reduction was attempted. Investments were visibly cut off. For the first time in many years spendings on defense were reduced. Still the Parliament agricultural lobby did not allow the government to reduce budget spendings on agriculture which exceeded all reasonable limits. In the plan for 1990 they make up 24% of all budget expenses (12% of GNP). These government measures have reduced the budget deficit down to 40 billion rubles (7.4% of GNP) for the plan for 1990. Nevertheless, all these measures are quite insufficient in order to get out of the crisis and to stabilize the economy.

Purely theoretically the working out of the program aimed at the economical stabilization is not difficult. It includes such widely known measures of harnessing the inflation and balancing the market as liberalization of prices, fixed limits on population income, sharp increase of interest rate, cutting down of the state budget, including here liquidation of dotation burden, freezing of investments, making the national currency convertible, doing away with the monopolistic structures, etc.

In the report we tackle only fiscal and monetary aspects of the policy of economic stabilization.

## **Fiscal Policy and Stabilization of Economy**

Fiscal policy should be changed in two ways. Whilst stabilization requires for more drastic reduction of budget spendings, the market reform demands that the principles of budget formation should be changed and the sphere of its application be shifted.

The Soviet economy is known for the excessive development of its redistribution processes. Over 50 percent of GNP is redistributed in the state budget. In 1989 the budget redistributed 55 percent of GNP. The 1990 plan reduces the figure by three percent and still the cosmetic reduction in the centralized redistribution processes achieve nothing because principally new approach for determining the sphere of activity of the state budget is necessary. The budget financing should include only those needs of the society that cannot be satisfied through the market mechanism. Only the expenses requiring political decisions should be budgeted. And this is the general principle of organizing the activity of the state budget. Today to get out of the financial crisis one should dramatically reduce all his expenses by means of shrinking the sphere of budget activity as well as by cutting down the



traditionally budgeted expenses, defense for example. As a result the budget share in GNP should fall down to 35–40 percent. The restriction should concern almost all budget items except social and cultural events. If stabilization of economy is the goal, then all other goals should be sacrificed. In 1990 centralized investments except investments in social and cultural sphere comprise 40 billion rubles or 8% of budget expenses. These should be reduced by at least 10 times. All new construction at the budget expense should be excluded. Reduction of dotations and expenditure on defense should be not less strict. It is also understood that one should refuse all kinds of free aid to foreign countries. Economic stabilization is incompatible with the financing of great-power ambitions.

As the process of adoption of economic decisions becomes more and more politicized liquidation of budget deficit becomes a convenient political slogan. The Parliament should consider the “zero” variant, i.e., the budget scheme with balanced income and expenditures. Additional demands for the financial resources of all interested social groups might be satisfied through additional targeted taxation or by the reduction of concrete expenses that should be defined by those who ask for these resources. This should be a clear process so that both the Parliament members and society in general could easily see the price of their suggestions.

The budget deficit is to be calculated according to the IMF methodology. This will help us to avoid debatable points when determining the budget deficit to deprive the Ministry of finance of the possibility to manipulate the statistics, thus disinforming the society and the Government.

Stabilization of economy demands thrift-mindedness not only from the state, but from enterprises as well. In the Soviet-type economy there is no selection mechanism of investments on the basis of their potential effectiveness. Under these conditions economic stabilization demands sharp reduction of all investment activity. In the USSR 1989 saw an attempt to limit such an activity. Budget investments were somewhat reduced but this did not bring about construction on a smaller scale because the reduction in budget investments had been compensated by investments coming from the own funds of the enterprises. In order to limit their investment activity radical measures are necessary among them sufficiently high investment taxes are necessary.

Supporting the activity of unprofitable enterprises makes a heavy burden on the economy. At present 7–8% of all enterprises are unprofitable. In 1988 the total cost of unprofitable industrial output was 43 billion rubles (5% of GNP). Though with the distorted prices system existing in the USSR unprofitability is not necessarily connected with ineffectiveness, there is a

substantial number of enterprises whose unprofitability is caused by exactly this factor. In those cases where it is not possible the losses should be covered not from the budget and not by a ministry but by a corresponding trade union perhaps with the help of the All-Union Council of Trade Unions. Let the official trade unions which stepped up their activity in the time of reconstruction demonstrate their "solidarity with the workers" instead of fighting with high income obtained by cooperatives.

Reduction of the expenses alone is not enough, and it should be accompanied by a bigger state income. When a person is unable to pay off the debts he should sell his property. The same should be applicable to the state. If the state cannot decrease its expenses than the outstanding deficit should be covered by the sales of enterprises, earth, buildings, housing funds, freely convertible currencies, etc. The sales are done at free prices (with a wide recourse to auctions) to all those willing, both to collectives and private individuals including foreign organizations and residents. The program of economic stabilization requires purchases of consumer goods at the external market. The goods are to be realized at the internal market at increased prices which should not be below their price in freely convertible currencies recalculated by the black market rates. The basic part of price increments should come from customs duties and turnover taxes flowing into the budget. The imported merchandise may be paid through changes in import structure (reduction or complete ending of equipment imports, etc. for the period of stabilization program) and/or greater external indebtedness.

Normalization of sales of alcoholic drinks, their greater production and sales in accordance with demand make up a certain reserve for the increase in the state budget income.

What is required now is a complete overhaul of taxation system and taxation policy. In the context of finance decentralization there comes a question as to what extent should the income of enterprises be withdrawn into the state budget. In 1989 49% of industrial profit was channeled into the budget. The greater part of these funds withdrawn from enterprises returns then into industry in the form of budget allocations. In 1989 budget allocations into the national economy less dotations to compensate for price differences almost equaled that coming into the budget from the profit of enterprises. Having unleashed the market reform there is no reason to deprive the enterprises of half of their profits just to distribute this money later as centralized allocations. The part of the industrial profit withdrawn into the budget should be reduced to 30-35%.

System of profit taxations of enterprises must be as simple as possible. Taxes and rules of taxation should be universal for all enterprises regardless of their financial condition, branch membership, administrative subordination, forms of ownership or some other factors having to do with individual peculiarities of this or that enterprise. The tax rates are not to be allowed to come down with lower profitability and vice versa. Any possibility for bargaining between an enterprise and the state on the question of tax rate should be eliminated.

Tax rates are determined on the basis of the following three principles:

- A. ensuring fiscal interests of the state budget;
- B. enterprises should have money left for an unfailing functioning of economy and its normal development;
- C. taxation scale should be moderate without causing destimulation effect.

One should reject all forms of administrative reglamentation as to the expenses of enterprises. The latter should have a possibility to spend the money the way they want to.

Whilst the enterprises are not privatized they will unavoidably be interested in inefficient spendings. In hierarchical system they are interested in inefficient investments. When transferring to self-management there is a need to maximize payments for labor expenses. Under these conditions both these kinds of payments and the investments should be taxed. In this way the taxation will include profits, property and expenses of enterprises, i.e., investments and wages and salaries.

## **Monetary Policy and Stabilization**

Within the historically conditioned framework of Soviet socialism model there have been functioning two parallel processes. On the one hand the state turning the emission mechanism into a plan appendage used effectively the methods of inflation financing of expanded reproduction, on the other hand it followed the policy of suppressing inflation symptoms by way of a rigid control over wages and salaries, administrative price formation and forced placements of bonds. For this reason the inflation processes took place in three forms simultaneously, i.e., suppressed, latent, and open ones.

Inflation causing chaos and destabilizing the economy reinforced social tension posing a serious danger to democratic achievements. Hence not an insignificant temptation arises to put it under control within the shortest time

by means of extraordinary measures. One should not forget however that inflationary tendencies are "built-in" in modern economic structures and all attempts of forced balancing between demand and supply being aimed at the consequences and not at the causes will have only a partial and temporary effect. Economic environment which would include "stabilizers" of unbalanced situations cannot be created with one stroke.

The main task now is not simply to withdraw excessive money but to put barriers on the way of incoming excessive means of payment. The more so that in this country we speak about excessive money against the background of its insufficient merchandise coverage. One should concentrate attention on the working out of such mechanism of monetary and credit regulation which would cause a disciplinary effect on the national economy as a whole.

The Soviet economy is faced with a dilemma: the increasing state control may stifle the inflationary growth of prices only at the expense of further growth of deficit and the strengthening of the "shadow economy"; the weakening of the state control will legalize the "shadow economy" and soften the deficit problem while sacrificing relative price stability. The vicious circle can be torn only by coming out of the limits of circulation sphere. Under these circumstances at the initial stages of stabilization policy it is worth while to put an accent on the production factors of economic growth, attempting to form antimonopolistic economical environment promoting various forms and ways of labor activity.

Simultaneously it is necessary to start forming in the most energetic way such mechanism of monetary and credit regulation which would allow the State bank to have means to influence effectively the dynamics and structure of aggregate money supply. Inflation can be harnessed and controlled if only the passive emission policy is rejected. Enterprises should be facing more and more "rigid" financial limits and the State should learn to live according to its means.

In every country inflation process has its own specifics which means the use of various combinations of short- and long-term financial sanitation. In the USSR inflation has interwoven with goods and budget deficits, with enormous above the norm stocks of goods and material valuables, growth of external indebtedness, latent unemployment, aggravation of national relations and industrial stagnation. The present situation is best characterized by such terms as deficitflation and stagflation, i.e., combinations of deficit and stagnation with inflation correspondingly.

Anti-crisis program to our mind should have specifics of a continually recurring compromise market with realism and continuity. It is worth while

to determine short- and long-term aspects of economic sanitation which in real life will overlap.

What is to be done in the long-term perspective?

- (1) It is strategically important to form gradually an antimonopolistic economic environment which might be called a system of regulated market. The existing economic mechanism does considerable factors of ruble depreciation is the artificial monopolization and undeveloped competitiveness of economic environment.

The difficulty of overcoming the actual situation lies in the fact that the historically formed administrative and command environment rejects the introduced market elements which become deformed thus causing quite a reverse effect. One cannot admit as expedient the organization of socialist markets by non-market means. The more extensively such measures are used the further the full-fledged market becomes. In force of what has been said before such transfer will be a long process with the gradual implantation of new elements into the old structure and its qualitative change after sufficient enough "critical mass" is achieved.

It is important:

- to deepen the reconstruction of credit and finance system in accelerated tempos without the radical renewal of which the market economic environment will be devoid of stability and integrity;
- to increase the role of monetary, credit, budget and tax regulation which are called to occupy with time the key position in the mechanism of state control over the economy;
- to develop purposefully but without artificial pushing the financial infrastructure, i.e., money markets, credit, securities and currency markets, bearing in mind the system of the ever growing "rigid" financial limitations and flexible mechanism of overflow of material and money resources;
- to create conditions for the gradual discontinuation of directive price-fixing and tentative widening of the scope of flexible price-fixing depending on demand and supply through several methods of pricing policy;
- to stop with time the administrative control over wages and salaries, their regional and branch structures giving these functions to labor markets which would be strictly controlled and socially protected;
- to come gradually from the lowest to more and more sophisticated forms of wholesale trade by means of production putting an ac-

cent initially on marketing and information services and then – on specialized companies and real commercial centers;

- to form prerequisites to the step by step transfer to the ruble convertibility, first a partial one, and in future – more and more complete one;
- to end the working out of the package of legislative acts, among them – antimonopolistic one which would form legal mechanism for the functioning of the socialist market and its control.

(2) Normal functioning of the Soviet economy is impossible without its gradual integration into the world economic structure. These ends should be pursued by the strategy of structural and investment policies. At present it is critically important to determine in what sectors of the world market the Soviet Union can assert itself on the basis of expert analysis, possibilities of the Soviet economy and world industrial trends.

If one wants to be realistic, it is high time to recognize that the breakthrough to competitiveness is impossible to achieve on one's own. Hence the need for long-term orientation on supply and sell, industrial, scientific and technical cooperation with industrialized and in some cases developing countries. It would be expedient to refuse rather chaotic changes in the foreign economic activity what has been reflected in particular in hasty decisions and then in prohibition on certain types and forms of cooperation with foreign partners.

(3) Normalization of the national economy is impossible without the gradual overcoming of structural disproportions. This concerns correlation of production of means of production and consumer goods in industry, branches of extractive and processing industries, lagging behind of agriculture, social and information and transport infrastructure lagging behind the national dynamics, non-coordination in the development of many branches, sub-branches and regions of the Soviet economy. First comes the task of achieving real changes in structural policy, overcoming the established priorities in material and technical supply, wages and salaries, policy of capital investments. Changes not in words, but in reality should be subordinated primarily to the development of agriculture, consumer goods production and social infrastructure.

Besides long-term strategy short-term set of measures is necessary.

(1) It is important to create conditions for stimulating the supply of goods without substantial growth in capital investments. This can be achieved

by the all-out development of shareholding elements and stimulation of alternative forms of economy like leasing, various models of cost-accounting, joint ventures, cooperative and individual labor. Freeing of enterprises, unions and different associations from the dictate of vertical structures is also very important. Support of small enterprises may be a great reserve of effectiveness growth giving the quick pay-off especially in agriculture, trade, services, and utilization of waste.

- (2) Determining the time limits and the scale of diminishing the state budget deficit is much worthwhile. In any case the Supreme Soviet of the USSR should annually confirm the maximally allowed limit for the state debt. Besides the budget deficit should be formed in the way of government securities.
- (3) Conditions for stimulating savings among enterprises and population are necessary. Forms and ways of outflow of monetary funds from the sphere of active to passive circulation should be developed. Now one very rarely uses such forms of funds attracting as long-term agreement deposit, targeted interest-free deposits for the durables, real estate loans, pension funds with a premium, stamp deposits, securities placements. Interest with a premium, stamp deposits, securities placements. Interest rates on deposit operations should become more flexible, depending on the terms and kinds of money deposited.
- (4) Restructuring of the banking system should be critically important in the program of anti-inflation measures. Its basic lowest level should be comprised of commercial banks and other credit and financial institutions acting on the principles of cost-accounting and interbank competition. The state specialized and commercial shareholding banks should be put in equal conditions. All of them should function on the basis of really attracted funds and be governed by the uniform rules of monetary and credit regulation. Interbank relations as well as the relations of banks with enterprises and organizations should be built exclusively on the agreement basis.

The State Bank of the USSR provided with the functions of banks bank and creditor of last resort should form the upper level of the banking system. Especially acute is the question of substantial changes in the status of the State Bank of the USSR within the structure of central economic bodies. Not in the least interfering into the cost-accounting activity of the banks the USSR State Bank should get in his hands the control of operative regulation of the aggregate cash and cashless monetary circulation in accordance with

the legally established goals of monetary and credit policy. It is worthwhile to gradually leave the principles of cash and credit planning substituting them by government securities placements in the banking sector (operations in the open market), variations by reserves, flexible interest policy and fixing standards of bank liquidity.

One should foresee a gradual transfer to the fixation of goal-reference points of monetary supply which should harness and discipline the national economy and state expenditure. These points should be correlated with the dynamics of the social product, national income, prices, and other basic economic variables. They should be fixed depending on the basic economic conjuncture and priorities in the monetary and credit policy. Taking into account the primitivism of economic mechanism of the monetary and credit regulation it is not expedient to fix rigidly goal-reference points in the use of monetary funds. For that end it is necessary to accumulate the experience of the working out of corresponding economic and mathematic models.



# The Soviet Tax System: Heritage from the Past and Blueprint for the Future

*Peter O. Aven*

“The radical economic reform”, announced by the Soviet leader Michail Gorbachev in 1985, is still on the drawing board. Inconsistency and indecision of the “reformers”, the lack of clear idea about “the good economy”, opposition of different social groups and several other reasons did not allow to carry out crucial measures, indispensable for the transition to market economy. However, the significant feature of the last few months is the emergence (for the first time since 1964) of the system of practical measures proposed by the Government for subsequent implementation. Proposals for the tax reform are among them. The analysis of these proposals permits to comprehend not only the position of the Government concerning the reform, but also some obstacles impending its fulfillment.

**The state sector.** In spite of rapid development of the private sector, in 1989 state enterprises still have been produced more than 90% of the GNP. Therefore, changes in “their” taxation system are of specific importance. As a matter of fact, this system ought to be created from scratch. “Command” (or, more precisely, “bargaining”) economy, existing in the Soviet Union, does not presuppose strict division of financial resources between an enterprise and the state. In fact, payment of expenditures and distribution of earnings until recently have been accomplishing from the one “joint pocket”. (Let us recollect F. Engels’ vision of a socialist economic system as of “one large factory”). The amount of resources, obtained by the enterprise, was and still is determined not only by efficiency of its operations but (and mainly) by its ability to “squeeze out” money from the state (usually

represented by branch ministry). Not only the assortment of goods for production, but also financial plan (containing certain planned earnings and proportions of their distribution between the enterprise and the state and also between various funds, created in the enterprise) were given to each producer in the beginning of each year.

Naturally, the financial plan was linked with the assortment plan, planned expenditures, etc. Also naturally, all these plans frequently could not be fulfilled (partly because of their poor quality and partly due to changing environment). The concordance of "deviations", the distribution of "superfluous" (non-planned) earnings or, on the contrary, the discharge of unexpected losses have not been accounted for in the legislation. Such questions have been solved in permanent vertical (hierarchical) haggles, where the solution of financial problems has been linked with the assignment of various material resources to the enterprise, its readiness to fulfill new, and often non-profitable, work quotas, etc. (Hence: "bargaining economy", "soft budget constrains", and rules of resource allocation which hardly could be formalized.[1])

In fact the actual absence of any rules with respect to the immobilization of financial resources from a firm has been reflected in the legal existence (until recently) of the notion of "spare remainder of profit", that is "superfluous" income, which has to be withdrawn from the enterprise. Under such conditions any discussions about "the tax policy" did not look serious – all questions of taxation have been solved on an individual basis, although certain preferences, for instance, for specific branches have always existed.

Despite general "fuzzy" financial relations between enterprises and the state, several attempts to introduce some fixed, obligatory payments were made in the last 10–15 years. Among them: payments for fixed capital, labor and natural resources. In the economy of "common pocket" all such payments (which were intended to stimulate efficient use of various resources) could not seriously influence the behavior of the enterprise. Frequently enterprises were liberated from such payments or their rates were reduced. (In October of 1989 Soviet Prime-Minister announced that only 28% of state enterprises could afford payments for fixed capital at the usual level of 3% of its value. Therefore, the rest pays less or just nothing.[2])

Persistent attempt to establish more formal, clear relations between the state and enterprises took place in 1985 within the framework of the so-called "Large-scale economic experiment". The main idea of this experiment: introduction of stable rates for income distribution both between the state and the enterprise and within the enterprise. Stable rates ("normatives")

had to provide certain guarantees for enterprises and, therefore, to stimulate more intensive operation. Although, normatives ought to be not only stable, but also unified (at least for the group of enterprises), neither the first, nor the second requirements were fulfilled. The impossibility to provide the unification of normatives has been caused by essential differences in production conditions and by deformations in the price system (so, instead of a real tax, individually settled “quasi-taxes” were implemented).

Instability of tax rates resulted from the preservation of the traditional system of simultaneous allocation of plan targets and material resources between state enterprises. In such a system the state (imposing plans and providing resources) is obliged to share the responsibility with the enterprise. Hence, if the financial situation of an enterprise has been worsening, then tax rates should be reduced – the state ought to provide necessary help. On the contrary (though less typically), normatives could be increased for “disobedient” or “too wealthy” enterprises. Their money has been used to support “poor” producers. (Impossibility to maintain the stability of tax rates within the context of centrally planned economy was widely discussed in Hungary in the middle of seventies.[3] The Hungarian experience also proves that in conditions of “quasi-market” haggles on tax rates supplement more important bargains on plan targets and supply in material resources.)

The role of the state in “correction” financial status of enterprises and the role of enterprises in forming the state budget are reflected by the magnitude of payments from profits and their share in the state budget. In the period from 1970 to 1987 the share of state enterprises in total earnings of the budget varied from 29,2% to 34,6%; average enterprise paid from 59% (in 1970) to 46% (in 1987) of its profit.[4] The certain decline in payments resulted from the general decentralization of the economic system – until recently decentralization and increased rights of enterprises remain main features of transformation associated with the “radical economic reform”. According to the plan in 1990 90% of increase in state enterprises’ profits will be left in their disposal.[5]

The ideology of stable economic normatives was consolidated by the “Law on state enterprise” in effect since January 1989. Individual settling of rates, as well as their factual instability were not overcome. However, the introduction of the new law marked a further step into direction of clarification of financial relations between the state and enterprises. Thus, spare remainder of profit, whose share in earnings of the state budget declined from 15,8% in 1970 to 2,9% in 1987.[6] was eliminated totally.

At the same time, legal framework for further and crucial decentralization, provided by the "Law on state enterprise", resulted in growing difficulties to increase tax rates. Frequent reduction of normatives without adequate increases is among main reasons for the rapid growth of the state budget deficit (11% of the GNP in 1989.[7])

**The private sector.** The emergence of private firms ("cooperatives") in 1987 called for the elaboration of specific taxation rules. While cooperatives were obtaining candid support from the Government, tax rates were relatively low. Contrary to state enterprises where tax was paid on profit, private firms were obliged to pay tax from the so-called "gross income" (earnings minus expenditures on material resources, compulsory and debt service payments). Irrespective of production, the tax rate was equal to 3% of the gross income at the first year (year of firm's establishment), 5% - in the second, 10% - later on.

In accordance with the changing attitude towards private business, taxation rules were also modified. Several modifications took place during last two years - after each of them conditions for private firms became less favorable. In the beginning of 1990 private companies that sell their products by regulated ("state") prices have to pay tax on gross income with the rate 6,25% in the first year of operation, 12,5% - in the second, 25% - later on. For those who operate with free, market prices corresponding numbers would be 8,75, 17,5, 35%. (As a result some entrepreneurs have already "closed" their "old" firms and opened "new" cooperatives in the beginning of the year.) For firms involved in certain types of activity (i.e., retail trade) tax rates might be increased by local authorities - the limit of such increase is 60% of the gross income.

Some additional payments also exist. The most important (tax on the wage fund) will be discussed below. The other important tax is the "tax on hired workers" - in order to lessen the threat of "exploitation" and to compel owners to accept employees for cooperative, gross income tax ought to be increased by 25% for those cooperatives where the number of hired workers exceeds three times the number of employers. Payments for fixed capital, labor resources, etc. also take place. As a matter of fact, permanent strengthening of the "tax pressure" puts under question future development of the private sector (whose production has grown for about eightfold during last year). In the attempt to prevent growing outflow of employees from the state sector the government jeopardizes the existence of private business in itself.

**The turnover tax.** While different schemes of taxation are applied to state enterprises, private firms and population, one unified tax is used for all. It is the so-called "turnover tax", that is addition to a seller's price paid by a consumer and transferred to the state budget. Traditionally receipts from turnover tax is the extremely important mean of fiscal policy – in 1960 such receipts exceeded 40% of the budget 8, in 1989 their share was more than 25%.[8]

However, the main aim of this tax is not a fiscal one. Its existence is determined by the necessity to correct discrepancies in the price system, to balance the situation on the market. Today receipts from turnover tax are almost totally compensated by subsidies to retail prices on consumer goods (in 1989: 111,1 bln. roubles from the turnover tax [9], 87,8 bln. subsidies only for food stuffs.[10]. Although certain corrections of prices are absolutely legal, their level in the USSR is definitely excessive. The magnitude of receipts from the turnover tax reflects the artificial character of the price system. The turnover tax, whose rate without any consistency is individually settled for every good produced in the economy, cannot help to overcome such artificiality.

Despite several proposals to substitute turnover tax by more "civilized" taxation (for instance, by value added tax), such substitution never was seriously discussed by the government. On the contrary, a 17,1 bln. roubles increase in receipts from the turnover tax is planned for 1990. Such orientation naturally results from the impossibility to perform radical reform in the price system in current social conditions.

**Enterprises: the new blueprint.** The new blueprint for the tax policy ("The draft law on unified tax system in the USSR") was proposed by the government in October 1989 and after rather long discussions approved by the Parliament in March 1990 with minor changes.

According to the blueprint, the Soviet state and leased enterprises, shareholding companies and joint ventures will be subject to three different payments:

- tax on profit;
- tax on wages fund;
- turnover tax.

For the private firms and public organizations tax on gross income substitutes tax on profit.

Payments for all resources except land will be abandoned (though, according to official statements, payments for labor may be reintroduced later on).

The blueprint reflects the general logic of the economic reform. According to it the state and enterprise pockets ought to be distinguished for all firms irrespective to the form of ownership. Declaring once again the path to stable tax rates, the Government took serious step in the direction of their unity. It is assumed that all state and leased enterprises will pay profit tax consisting of two parts. The first, transferred to the union (federal) budget, will have unified rate of 30%. The other, paid into the budget of a republic and settled by it, may vary between republics (but has to be unified within each of them); its rate can not exceed 25% of profit. (Within the framework of the economic reform special attention is paid to the "financial independence" of Soviet republics. For the first time the share of republics in the state budget is going up – in 1990 it will reach 49,3%, compared to 45–46% in 1988–1989).[11]

Simultaneously, system of tax privileges will be introduced. According to the Prime-Minister, such privileges will be obtained only by those enterprises, who increase production of consumer goods, invest into ecological programs or are in the period of technological transformation. Taking into account the system of privileges, planned average level of taxation ought to be equal to 48–49%.

Total receipts from the profit tax, calculated on the new basis, for 1990 are estimated to reach the level of 98 bln. roubles. If the scheme, used in 1989, would not have been changed in 1990 the receipts would be approximately 10 bln. less.[12] Therefore, the new proposals indicate further movement in the direction of decentralization. (The weakening of the tax burden is directly connected with the crucial decentralization of capital investments. From 1986 to 1989 the share of "local" (enterprise) investments in total capital investments into the state sector grew from 3,1% [13] to 46,6%.[14]

The idea of tax, which consists of two parts, reflects the aspiration to exclude tax rates from a set of objects used in bargaining. As for a large number of enterprises plan targets still "come down" from the state level, their admission no longer can be linked with changes in normatives. However, the introduction of privileges retains the possibility to bargain legally for tax rates – it does not seem very difficult for almost any enterprise to link itself with one of the prerequisites, necessary for exemption. Moreover, possibilities to haggle with the republic authorities (who now are obtaining more rights in planning and distribution of material resources) may be in-

creased – in a certain sense the state is shifting the responsibility to adjust economic regulators to the “shoulders” of local managers.

It seems that definite stability and at the same time flexibility of economic normatives could be provided not by the system of privileges, but by clustering enterprises according to their conditions of production. Proposals on such clustering exist.[15] However, the Government has chosen another road, which better coexist with the preservation of administrative control.

As for the private sector, the new blueprint in general does not presuppose serious changes in taxation. Maximum tax rates of 25% and 35% will stay. For cooperatives involved in some type of services and retail trade these rates can be increased (limits of such increase are not determined in the Law). Private firms in areas of construction, agriculture and food processing, selling their production at state prices, are liberated from any tax on gross income during first two years of their existence. All others pay 25% and 50% of the tax respectively at the first and the second year. Precise determination of tax rates is given to republics. Receipts from the tax are transferred into local (municipal) budgets.

Precise scheme of taxation for joint ventures and foreign firms, operating in the USSR, will be defined separately.

**The tax on wages fund.** The decentralization of decision making, growing rights of enterprises (especially in areas of pricing and wages) resulted in the increase in average wages outstripping labor productivity. In 1989 average wages in the state sector grew 9,5%, labor productivity increased only by 2,3%, production of consumer goods by 5,9%.[16] Rapid growth in both shortage and prices (despite state control) made it necessary to constrain further increase in wages.

Contrary to the generally “soft” taxation of profits, special (and very tough) regulation of the increase of the wages fund was introduced in October 1989. According to the decree, issued by the Soviet Supreme, all state and cooperative enterprises ought to pay special tax if the annual growth rate of their wages fund exceeds 3%. The scale of rates for such payment can be found in *Table 1*.

In fact such a system (which for some time has been used in Hungary) has frozen wages. No doubts, it could not stimulate intensification of labor efforts. However, within the framework of this system average wages at the enterprise might be increased: all what has to be done is to reduce the number of workers. Hence, further growth of unemployment can be anticipated. Additional outflow from the state into the private sector also

**Table 1.** The tax on wages fund: the scale of rates.[18]

Annual growth of wages fund – %	Payment into the state budget (roubles for every rouble of increase in wages fund)
less than 3	0
from 3 to 5	1
from 5 to 7	2
more than 7	3

seems probable: by establishment branch companies cooperatives may try to escape new taxation.

Results of the last quarter of 1989 corroborated all these threats. Under the pressure from state enterprises, losing their labor force and decreasing production, the government issued numerous exceptions, permitting enterprises to pay less. As a result of individual bargaining on tax rates, receipts from the tax on wages fund appeared to be two times less than it was anticipated (0,5 bln. roubles instead of 1 bln.).[17]

Realizing this situation the government changed its mind and in the beginning of February announced important modification in the tax scheme (although in October the promise was not to change it during 1990). From now on the basic wages fund (earlier the fund of the previous year), which is used for the calculation of growth rate, can be increased to 0,5% for every 1% growth in production (for machine building and metal-working industry the rate is 0,3). Simultaneously the basic fund ought to be reduced to 0,7% for every 1% decrease in production.[19]

**Population.** According to the traditional system of proportional taxation, which has been existing since the twenties, every soviet citizen, being paid by the state, had to pay 13% of his earnings as an income tax every month. Some exceptions (in timing of payment and its rate) took place for freelance persons.

The emergence of cooperatives resulted in widening of legal possibilities to earn money outside the state sector. After some discussions all personal incomes of members of cooperatives and their employees were taxed at the same level of 13%. At the same time incomes from legal but not registered (at the status of private firm) activities (i.e., from growing and selling fruits and vegetables from “private supplementary holdings”) until now have not been taxed.



**Table 2.** The income tax: the progressive scale.

Income per month (I) (roubles)	Magnitude of payments (roubles)
less than 80	0
81-100	0,41 * (I-80)
101-700	8,2 + 0,13 * (I-100)
701-900	86,2 + 0,15 * (I-700)
901-1100	116,2 + 0,20 * (I-900)
1101-1300	156,2 + 0,30 * (I-1100)
1301-1500	216,2 + 0,40 * (I-1300)
1501-3000	296,2 + 0,50 * (I-1500)
3001-5000	1046,2 + 0,65 * (I-3000)
more than 5001	2346,2 + 0,80 * (I-5000)

In addition to income tax some less important taxes also have been existing. The most controversial one is the tax on bachelors and married people without children – 6% of earnings are under taxation. Among other minor taxes: the road tax (on private cars), the agricultural tax (on land property) and the inheritance tax. No other property taxes have been existing.

All together tax receipts from the population stably reached 7–7,5% of the state budget.[20]

“The draft law on change in organization and rates of taxation on population” was proposed for nation-wide discussion in April 1989.[21] According to the draft law, first of all, some evident “unfairness” ought to be excluded from the tax system. One of them: the tax on bachelors and married people without children which will be at first abandoned for low income persons and then in 1993 for the rest of the population.

However, the real significance of the new blueprint is connected not with such minor changes. The main thing is that traditional system of proportional taxation ought to be substituted by progressive income tax. Its scale, proposed in April, presupposed progressive taxation only for rather high incomes – for more than 7 hundred roubles per month (average wages in the state sector in 1989 was equal to 240 roubles).[22] Later on progressive taxation was widened for all levels of income – its scale (proposed by the Government and almost without changes approved by the Parliament in March 1990) can be found in *Table 2*.

The transfer to the system of progressive taxation reflects growing anxiety with the probable incomes differentiation, which might result from the

development of the private sector and market in general. In fact, such fears are essentially overestimated. The transition to the market can hardly increase current differentiation, where inequalities in earnings (in 1989 in 12,6% of families per capita income was less than 75 roubles per month, in 7,1% the income was over 250 roubles, for families with income from 75 to 100 and from 200 to 250 roubles corresponding numbers were 15,7% and 10,1% respectively [23]) is supplemented by complicated system of privileges. The destruction of such a system (which, for instance, allows social groups with higher incomes to pay for some consumer goods at half the average price) may influence factual distribution on national income much stronger than proposed changes in the tax policy.

### Notes

- [1] See, for example, classical book of J. Kornai, *Economics of Shortage*, Amsterdam, North-Holland, 1980. On the Soviet case, see P. Aven and V. Shironin, *The Reform of the Economic Mechanism: the Realism of the Projected Transformations*, Problems of Economics, June 1988, Vol. XXXI No. 2 (in Russian).
- [2] Izvestia, 3 October 1989.
- [3] See, for example, R. Nyers and M. Tardos, *Enterprises in Hungary Before and After the Economic Reform*, Acta Oeconomica, Vol. 20 (1978), 1-2.
- [4] *Narodnoye Khozyaistvo SSSR v 1987 g.*, Moscow, 1988.
- [5] Izvestia, 26 September 1989.
- [6] Same as 4 above.
- [7] Same as 5 above.
- [8] Izvestia, 28 January 1990.
- [9] Same as 8 above.
- [10] Same as 5 above.
- [11] Same as 5 above.
- [12] Same as 2 above.
- [13] *Capitalnoye stroitelstvo SSSR*, Moscow, 1988.
- [14] Same as 5 above.
- [15] See, for example, S. Alecsashenco *et al.*, *Nalogovie shchaly: functsii, svoistva, metody upravleniya*, Economica i Matematicheskie Meyody, 1988, no. 3 (in Russian).
- [16] Same as 8 above.
- [17] Izvestia, 9 February 1990.
- [18] Izvestia, 11 August 1989.
- [19] Same as 18 above.
- [20] Same as 4 above.
- [21] Izvestia, 25 April 1989.
- [22] Same as 8 above.
- [23] Izvestia, 29 July 1989.

# Comments on the Paper by K. Kagalovsky and A. Khandruev

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My remarks will be divided into three general areas. First, I will begin with an overview of the general problem of radical economic reform faced by centrally planned economies like the Soviet Union. In the second section, I will address particular problems of economic stabilization, or what is called “macroeconomics” in the West. The final section contains some reflections upon the distribution of income in a market economy.

Before beginning, however, I would emphasize one point. The path of making the transition from a thoroughly centrally planned economy to a market economy is one that is without precedent in economic history. It is ironic, indeed, that the Soviet Union should for the second time in this century be forced to travel down a road that no country has taken before. Unlike the first journey, however, the shift from a command to a market economy is moving toward a well-mapped territory. We know a great deal about how the economies of the east will function once they have been transformed into market economies. The uncertainty revolves mainly around the transition from centrally planned market economy.

In light of this uncertainty and lack of experience about the transition path, we must be especially cautious about our prescriptions. In giving advice to policy makers, we must be prudent and admit that our analysis is based on analogies, theories, and hunches rather than on the wisdom from accumulated experience. It would be irresponsible for us western economists to propose bold and draconian measures – especially when we can go home

and enjoy high incomes even if the proposals fail. Caution must be the watchword.

## Section I

It is useful to begin with an overview of the problem faced by radical economic reform. There are three important themes that emerge from the papers for this meeting and in the background paper circulated at our last meeting [1]: (1) the ultimate goal of the radical reform, (2) the steps necessary to make the transition to the final goal, and (3) the sequencing of the transitional steps.

### a. The ultimate goal

With respect to the goal of radical reform, the goal of economic reform is to replace the command-administrative mechanisms of today's socialist economies with an economy primarily driven by a decentralized system of markets for most inputs and outputs. This is clearly stated in *Radical Reform* [2]:

[T]he main features of the model of a new economic system are ...the use of the market as the main form of coordinating the activities of the participants in production. We have become convinced on the basis of our own experience that there is no worthy alternative to the market mechanism as the method of coordinating the activities and interests of the economic subjects.

The major exceptions will be a number of industries that will continue to have heavy state intervention, such as the power grid, defense, transportation, and communications.[3]

An important point about the ultimate goal is that a market economy is not a *laissez-faire* capitalist economy. There are a wide variety of both microeconomic and macroeconomic interventions in a market economy that may be desired. But these interventions will, I assume, operate in the *framework* of a market system. That is, governments affect markets, but markets will determine the outputs, prices, and allocations of the multitude of decisions that must be made every day.

## b. The transition steps

Professor Yasin has stated clearly the question before us: “The essence of the radical economic reform in the USSR is the transition from the administer-and-command system to market economy.” The background papers for this conference, particularly *Radical Reform*, are a useful and thoughtful analysis of the problems of the transition. I find it useful to break the transition issues into the following set of questions:

- Stabilization: ensuring that the overall economy, or aggregate supply and demand, are in rough equilibrium in the economy. Some indications of aggregate disequilibrium exist, although the situation is different in different countries. This is the problem of “macroeconomics” that will be addressed at length in the next section.

- Price reform: Prices of both inputs and outputs are often far from the levels they would find if they were market determined. Schmelev gives the example of meat (selling for 50 percent of “realistic costs and world trends”), shoes and automobiles (twice realistic levels), and a color television set (2.5 times realistic levels). Sooner or later, if prices are to be market-determined, relative prices must be moved to the levels.

- Institutions of the market: The Soviet economy lacks many of the institutions that are required to make a market economy function. These include accountants and accounting standards, lawyers and contract laws, market research and salesmen, banking regulations and bankers. This list is written to emphasize that a market requires not only rules written on paper (decrees and laws) but also experienced people who understand and operate the institutions of the market.

- Privatization (or marketization) of individual sectors: At some point, in a gradual or abrupt way, the *actual decisions* about buying and selling, pricing and production, borrowing and lending must be made on a decentralized basis in markets. Buyers and sellers must negotiate, bargain, and argue about prices, quantities, and qualities. They must have alternative buyers and sellers available. The thousands of people who currently regulate prices and quantities must find other jobs.

There are many other things that will happen in the transition from a command economy to a market economy. But these stand out from the papers, and from my experience, as the crucial steps in the transition.

### c. What is the best sequence of steps?

There is little disagreement about the need for these steps on the road to a market economy. The critical question is the *sequencing and speed of the transition*.

#### (a) *Big-bang approach.*

One approach, which has been undertaken in Poland, is the “Big Bang” approach of simultaneous and immediate transition from a centrally planned to a market economy. This is labelled the “radical” option in *Radical Reform*. In this approach, you would remove all barriers to markets, decontrol all prices, and privatize all sectors immediately and simultaneously; then force markets to take over the role abandoned by the government. This approach is labelled purely “theoretical” in the background paper, but it is in fact a live option.

Is such an approach appropriate for the Soviet Union as a whole? I think not. This approach is a possible one for a small, open economy and one with some memory of markets (as occurred in Chile or may occur in Poland); or for isolated sectors within a largely capitalism system (as occurred for the airlines in the United States or for nationalized enterprises in the United Kingdom). However, in my opinion, such an approach is too risky for as large, closed, and hierarchical an economy as the Soviet Union. As an economist, I simply could not guarantee that such an abrupt transition would not lead to a major breakdown of the economy, with mass unemployment and even, potentially, widespread economic distress, breakdowns in the distribution chain, and hunger.

To use an analogy, we might ask how a country could best change from an inefficient language to a more efficient language (I use this example to emphasize that a market is as much a culture, a way of talking, and a complex set of human interactions like language as it is a new set of rules and regulations). Moving to the new system would be painless for those who already know the language, just as East Germans can easily adapt to West German regulations. But for those who are ignorant of the new language, it would be more efficient to introduce the new language gradually, to train people to speak the language of the market, to spend some time in countries where the language of the market is spoken, and so forth. To require a country to speak the new language immediately would lead to chaos or revolution or both.

*(b) Staged approach.*

If we reject the “Big Bang” approach for the Soviet Union, the next question is the appropriate sequence of radical reforms. I believe the best sequence is in two major stages: first, is to move the economy as close as possible to macroeconomic and microeconomic equilibrium and to set out the legislative framework for the market; then, second, to decontrol prices and privatize production. This approach is close to the “radical-moderate” option in the background paper.

*(1) Alignment.*

The first stage should attempt to move the economic variables as close as possible to the market and to remove the source of macroeconomic disequilibria. This would involve a thorough price and accounting reform to align prices as closely as possible to what free market prices would dictate. In doing this, it would be useful to introduce accounting and reward systems that would be appropriate when the transition to the market is made. We should not fool ourselves into thinking that the prices and incentives will be “correct” under this alignment stage. Rather, it is the purpose to remove as much as possible of the disequilibrium so that the disruption at introduction of markets is minimized.

In addition, the alignment stage should include the major macroeconomic adjustments to reduce the government budget deficit and align taxes and subsidies to reflect the new social priorities.

Finally, the alignment stage should begin the stage of introducing the institutions of the market, of training managers and others to “speak the language of the market.” This would involve legislation on contracts, bankruptcy, joint ventures, and banking; experiments on decontrol of certain markets; setting up a stock market; and establishing the social safety net (such as employment insurance) for those persons who are injured by the market economy.

*(2) Decontrol.*

The second and crucial step is actual decontrol of prices, freedom of entry and exit and bankruptcy, and privatizing markets. Much has been written on this subject and I will not expand on this second stage.

The final issue of the sequencing of the transition is *how rapidly* it should occur. There is no way to answer this question in general. It is useful to recall

that most western countries required decades if not centuries to develop the institutions of the market, to train managers and workers, to find an efficient balance between state and market in each sector. Surely, the economies of the East can learn from mistakes and successes of the West. In my opinion, it is hard to see how the first stage could be accomplished in much less than two or three years, and the two stages in much less than five years. To make the move more quickly would require gambling on the Big-Bang approach.

*(3) A tie-breaking rule.*

In the course of the transition, there will be a large number of options or routes to the ultimate goal of an efficient market economy. In cases where it is a close call between alternatives, a useful rule to help break the ties is the following: Choose the transition strategy that will do the maximum extent smooth or speed the transition to a decentralized market economy. The logic behind this tie-breaking rule is obvious.

An example is the following: Assume that there are two strategies for containing an inflationary burst after markets are introduced. One would be slow decontrol or control some prices; the other would be to open borders so that foreign goods could reduce market power. The tie-breaking rule will favor the second, for it will help marketize the economy more quickly. Although this sounds innocent, it is surprisingly powerful in many transition decisions.

The peril of ignoring such a transitional rule is seen in the current problem in the USSR, as I understand it. Because the reforms from 1985 to 1989 led to incomes outrunning supply, a movement has arisen to *recontrol* prices and move toward tighter central control. A defender of the recontrol might cite the famous dictum that progress requires two steps forward and one step backward. Without great vigilance, this easily becomes two steps backward for every one step forward – and thwarts reform altogether.

## Section II

I next turn to a discussion of the macroeconomic issues covered in the paper by Kagalovsky and Khandruyev and in the background paper. In my discussion, I will make a few background comments on the role of macroeconomic policy and then turn to the specific suggestions in the papers for this conference.



To begin with, it is useful to understand the role of macroeconomic policy. Macroeconomic policy has the responsibility of ensuring that the economy is in overall or aggregate balance. In the market economies, policies generally focus on the short-run stabilization and the long-run need for efficiency and economic growth. In my remarks I will discuss only the short-run stabilization problems, which are the most urgent in making the transition to a market economy.

For short-run macroeconomic policy, the most important goals are to ensure: that output is close to its potential, that unemployment is at as low a level as is sustainable, that prices are stable, and that the economy is in balance with the rest of the world. The major tools to attain these goals are fiscal, monetary, and external policies. That is, the goals can be achieved by fiscal policies (that relate to the structure and overall level of expenditure and tax programs), by monetary policies (which relate to the control of various monetary aggregates with an eye to influencing asset prices, interest rates, and credit conditions), and external policies (which include a variety of measures including the exchange-rate system and trade policies).

The central need for macroeconomic policy is to ensure that nominal aggregate demand does not grow much more rapidly than the potential output of the economy. In other words, the amount that different entities in the economy (households, enterprises, and the government) want to spend should be close to the current-price value of output. In addition, incomes should not be growing much more rapidly than the potential output. If either the total desired spending in the economy is much greater than the current-price level of output, or if the growth rate of current-price spending is much greater than the growth rate of real output, then the economy will have the tendency toward a burst of inflation, a sustained inflation, or even, potentially, a hyperinflation. Of course, if the opposite is true – if spending is much less than output – the economy may suffer a depression and high unemployment, but insufficient aggregate demand hardly seems the most immediate difficulty in most Eastern European countries.

The papers points to a variety of macroeconomic issues, but five particularly stand out.

First, the budget is seriously out of equilibrium. The budget deficit is almost 11 percent of GNP and about 22 percent of expenditure. The government debt is around 44 percent of GNP. There is both “stock” and “flow” disequilibrium in the government budget. That is, the accumulated stock of money and other liquid assets has led to a “ruble overhang.” Unless neutralized, the ruble overhang will produce a sharp, one-time rise in prices

when prices are decontrolled. The papers mention a number of options for soaking up the ruble overhang, none of them particularly attractive. If the ruble overhang is small, a small one-time price rise (up to, say, 20 percent) might be a reasonable option. If estimates point to a larger figure (say a 100 percent increase in prices), then some kind of monetary reform might be necessary.

What kind of monetary reform would be desirable? I believe that the first criterion should obviously be to stabilize aggregate demand. Among those many options that do so, remember the tie-breaking rule suggested above. In that, preference should go toward solutions that help rather than hinder markets. This would include introducing a new and convertible currency (such as the German reform of 1948), selling of state assets, or selling high-yield government bonds. Solutions that would impede markets (such as freezing accounts) should be rejected as hindering the movement toward more efficient capital markets.

Second, it is necessary to reduce the budget deficit so that the continued inflationary pressures are reduced. Put differently, if the budget deficit continues at high levels, the increase in aggregate demand will grow and the "inflationary gap" between desired spending at existing prices in real output will grow over time, producing continued inflationary pressures. I would therefore concur with the view of the papers that it is important to reduce the deficit so that whatever inflation occurs upon price decontrol does not ignite a self-sustaining continuing inflation. On the other hand, a budget deficit of 10 percent of GNP is not outside the range of experience of successful market economies. Japan and Italy, for example, have had deficits of this size in recent years, and the U.S. federal government deficit at its peak in the 1980s was 6 percent of GNP.

A related issue concerns the need on the one hand to protect those living on fixed incomes and the need to reduce inflationary risks – this is the issue of indexation. It is tempting to index pensions, transfer payments, and wages so as to protect those who suffer most from the ravages of inflation. While such steps are justified, care must be taken not to set the rate of indexation at too high a level. Full indexation (raising pensions or wages 1 percent for every 1 percent rise in prices) is an invitation to galloping inflation. The papers propose *partial indexation* – around .3 percent per cent on wages and .7 percent per cent on transfers – which is a level that has worked in Western economies.

Third, almost all observers of economies of the east believe that the structures of the budgets and of taxation are inefficient and undesirable. There

are substantial subsidies to food and agriculture (amounting to 24 percent of the USSR budget or 12 percent of GNP) and to unprofitable enterprises (about 10 percent of the budget or 5 percent of GNP). Defense probably absorbs 20 to 30 percent of the budget. An early objective of reform, which is a theme running through the papers, is the need to restructure the budget both to ensure macroeconomic stability, to align relative prices with social priorities, and to make room for growth in private consumption.

Fourth, it is a mistake to assume that centrally planned economies can avoid difficulties from excessive demand by controlling prices. In the last few years, as the papers point out, the USSR has lost control of the budget, and incomes are rising more rapidly than output. In an economy with price controls – whether the USSR in 1990 or the USA in 1944 – the result of excess demand is shortages, long lines, and an increasingly inefficient distribution system. One result of German decontrol of 1948 or of the Polish decontrol of 1990 is that goods magically appear in the shops. (The problem, of course, is that they are too expensive to buy!). The inefficiencies of repressed inflation are yet another reason why it is imperative for Eastern economies to get and retain control of their fiscal and monetary policies.

Fifth, the most difficult, is the need to reform money and capital markets. The papers correctly point to two elements in this strategy. First is the need to separate the central banking function from the commercial or retail banking function. All (sensible) western economists agree that the functioning of the monetary system, the provision for a limited supply of money and a stable currency *cannot* be left to the market. Here, the government has an important function as the monopoly supplier of bank reserves and as domestic lender of last resort. Gosbank is one institution that has a future no matter how marketized the Soviet economy becomes.

On the other hand, the *retail* lending functions should be decentralized and subject to regulated competition over time. The Soviet economy needs to develop a private, decentralized capital market, with strong banks, through which banks are middlemen between savers (in households, enterprises, and foreigners) and borrowers (for housing, plant, equipment, and inventories). Some investment of course will be financed by enterprises or households themselves. But in an efficient market economy, credit markets raise and distribute a sizable fraction of the funds for investment.

### Section III

As a final word, I would like to say something, speaking as a citizen, about the aesthetics and morality of a market. One of the major differences between a market economy like the United States of the 1980s and a socialist economy revolves around the importance of equality of incomes. Socialist societies value equality, while market economies permit, and sometimes even encourage, great inequalities.

Many people in today's America are repelled by some of the values that the market sets. I wonder about a society where a new lawyer gets paid more than a professor of physics; where a rich man can get his name on an airline ("Trump Air") or can own a baseball or hockey team; where baseball players make 100 times more than factory workers; where an investment banker can draw a bonus of \$500 million for selling junk bonds. It was this arbitrary income distribution that led my colleague Arthur Okun to say, "Two cheers for the market, but not three."

But whatever we feel about this issue, these excesses are the price of a market economy – where wages and prices reflect how well a product sells rather than how much it is really worth. Prices and incomes in a market are determined by dollar votes in the marketplace, not ballot votes in elections or bullet votes at the barricades.

But societies can take steps to correct the greatest distortions of incomes produced by a market. The lesson we would suggest is that the most effective and efficient interventions in the market distribution of income come from *income-tested taxes and subsidies* rather than from direct interference with price and allocations.

For example, most people would agree that the poor should not starve. One way to make food available to everyone is through food subsidies. This is unnecessarily expensive, however, because it benefits high-income as well as low-income groups. A more efficient policy is to *target* income-support activities on particular groups. In the United States, this is done through the food-stamp program, wherein low-income households (but not high-income households) can purchase at heavily subsidized prices. The same principle applied to medical care and housing. Or an even broader approach is to provide *income* to needy groups rather than providing *specific* subsidies.

Similarly, many economists from Eastern economies are uncomfortable with the concept of an individual holding large amounts of assets or hiring large numbers of people. I have seen suggestions on prohibitions of such activities. The difficulty, of course, is that such prohibitions might significantly

inhibit technological change and capital accumulation. Perhaps, if a society wishes to encourage entrepreneurship and private enterprise, it would be well to allow practices that are somewhat distasteful and to *tax* the proceeds of the investments rather than prohibit them. If I had a Russian grandfather, he might have said, "It is better to have rich peasants with fat hens than poor peasants with skinny hens. It is better still if we can tax a few of the eggs of the rich peasant to share with the rest of us."

### Notes

- [1] The background paper is *Radical Economic Reform: Top-Priority and Long-Term Measures*, paper distributed by the Organizing Committee of the All-Union Conference and Workshop on the Problems of Radical Economic Reform; this paper will be called *Radical Reform*.
- [2] *Radical Reform*, pp. 2–4.
- [3] *Radical Reform*, pp. 25.



# Stabilization and Reform Sequencing in the Soviet Economy

*D.M. Nuti*

## Reform Progress to Date

In the last four years the Soviet Union has introduced many measures of economic policy and radical reform intended to reduce the scope of central planning and to activate market mechanisms, in order to mobilize resources, increase their productivity directly and through greater integration of the Soviet economy into world trade, so as to resume and accelerate economic growth.

The first steps of Gorbachev's economic perestroika were neither felicitous nor effective: initially the emphasis was placed again on investment and technology in heavy industry, as in the old model; the anti-alcohol campaign aggravated the state deficit and had spillover effects on the demand for other goods, leading to shortages not only of sugar for illegal distilling but also of other consumption goods, whose imports were also reduced; the anti-absenteeism campaign relied on penalties, and economic incentives were reduced by the attack on speculation and individual enrichment; the new quality control procedures (Gospriemka) and the merging of five agricultural Ministries into Gosagroprom continued indeed intensified administrative control. Soon however genuine reform measures followed: the legalization and encouragement of individual labor activity; the promotion of cooperatives (originally without limits to earnings and to sector of activity, then subject to alternate restrictions and relaxations) and of joint

ventures with Western partners, not allowed majority stakes and expatriate management; the direct undertaking of foreign trade by a number of Ministries and enterprises without the necessary intermediation of the traditional Foreign Trade Organizations; the indicative and non-obligatory nature of central plans, the use of government contracts instead of direct orders, the establishment of direct links between enterprises (even across borders); the foundation of several new banks, including joint-stock-companies set up by state enterprises; authorized privatization of some state assets, through leaseings ("arenda") as well as direct sales beginning with some of the housing stock; partial retention of foreign currency earnings by Soviet exporters.

In the last year there has been an acceleration of the reform drive, especially in connection with international trade, namely:

- (1) The replacement of the traditional coefficients (variously estimated at between 2,000 and 5,000) correcting the ruble exchange rate according to specific trade areas and commodity groups, by a uniform 100 percent bonus on convertible currency exports (i.e., equivalent to a devaluation or revaluation in a given sector according to whether the previous correcting coefficient was lower or greater than 2), from 1-1-1990.
- (2) The announcement of a subsequent devaluation of the ruble in trade transactions.
- (3) The payment of additional agricultural deliveries by Soviet peasants partly in foreign currency from next year.
- (4) The announcement of Special Economic Zones similar to those operated by China.
- (5) The 25 October 1989 devaluation of the ruble by 90 percent (from \$1.6 to \$0.16) for non-trade transactions, i.e., personal transactions for both foreign and Soviet citizens; the rate was pitched close enough to black market rates as to reduce substantially if not abolish black market transactions; the official rate would be maintained for essential imports, while an intermediate commercial rate would be introduced for non essential imports and possibly also for the promotion of new exports.
- (6) The first foreign currency auction held by Vneshekonombank on 3 November 1989 (similar to those already operating in Poland and Bulgaria) at which the ruble was traded among state enterprises at a discount of over 95 percent with respect to the official rate; (as a result of the large dollar premium the export bonus announced for 1-1-1990 may now be raised above 100 percent and kept diversified).



There are also plans for further privatization, the overhauling of the banking system in order to replace automatic credit with competition in commercial banking, a tax reform, the establishment of a capital market, and further steps toward ruble convertibility. These measures were confirmed in the economic reform plan associated with Vice Premier Leonid Abalkin published by *Ekonomicheskaya Gazeta* in early November 1989.

## Sequencing Failures

At first sight this picture suggests that gradual but steady implementation of radical reform, bringing the Soviet Union ever closer to a model of "market socialism" and integration into the world economy, improving its efficiency at every step. In practice there is no sign of either greater efficiency or any significant change in the mode of functioning of the Soviet economy, to the point of Soviet and Western commentators lamenting the economic failure – so far – of perestroika (see for instance J.P. Hardt and S.N. Heslin' pamphlet recently published by the Group of Thirty, and Oleg Bogomolov's comments).

On reflection, economic reform has not so much failed, but has failed to

- (1) Take all the steps necessary to the activation of markets, namely: the permission of market clearing prices (whether through inflation or stabilization); the severance of enterprise links with central government bodies; the abolition of the monopoly power of large enterprises and their associations (moreover specialized by sector); the guarantee of the strictly residual nature of enterprise income, without enterprise-specific compensatory subsidies and taxes, individually negotiated *ex post* and *ad hoc*.
- (2) Follow an appropriate logical and operational sequencing of reform steps, and to follow it without reversals.
- (3) Reach, in any case, the scale necessary for the emerging system to have the minimum critical mass.

All these failures fall under the heading of "sequencing failures" in a broad sense, i.e., including under this heading the ordering not just of the steps actually undertaken but also of those which are missing, the irreversibility of those steps, as well as how far and on what minimum scale the sequence must be implemented for reform to succeed.

Unfortunately these failures are characteristic of all centrally planned economies attempting reform, in and outside Eastern Europe, none excluded.

Partly this is due to the lack of a clear cut, unambiguous and complete design for the ultimate target model to be achieved. As Alec Nove says, if you do not know where you are going all the roads will take you there. Obviously if such a model was fully developed and agreed upon the reform process would be greatly facilitated; unfortunately it is still not clear whether the target model is market socialism or a "socialist market" (Gavril Popov said recently: "We do not want to eat socialist sausage, just ordinary sausage"); whether this is to be a set of policies or a set of system-specific institutions, and what these might be. Nevertheless, reformers know perfectly well in which direction they want to go, the questions are rather how far to go, what to carry on the way and what to build once one gets there; these difficulties should not be overwhelming. The failures mentioned above are rather due to the simplistic nature of reform orthodoxy, and to ideological and above all political constraints.

## Reform Orthodoxy

The orthodox approach implicitly or explicitly dominating the reform process virtually everywhere is the following. Decentralization of economic decisions and the activation of markets has an instant, or at any rate very rapid, effect on resource mobilization and the efficiency, amplified by the reduction of defense expenditure (10 bn rubles this year, or 14.2 percent of the defense budget) and the restructuring from heavy industry to light and technologically advanced sectors. This supply response (Gorbachev's "uskorenie" or acceleration effect) will over a short period of time take care of existing excess demand without substantial price rises, though initially it may be necessary to use an injection of additional imports (figures of up to US\$25 bn have been mentioned; in October 1988 Gorbachev raised US\$10 bn in ten days, and some of it has already been spent). Of course relative prices will have to change but this can be done once the economy has recovered, by a price reform fixing prices and price criteria on the basis of international prices and long run domestic costs. Enterprise independence from the center can be achieved by abolishing branch Ministries and, as in Hungary, replacing them with a single Ministry for Industry. Banks will monitor them extending credit not automatically but according to their credit-worthiness. Competitive behavior even of large specialized firms can be obtained through international competition, hence the importance of trade liberalization and an early convertibility of ruble. Ideally the reform should be implemented

all at once (the “shock therapy” or “cold turkey” treatment advocated by George Soros for Poland; “you cannot cross a chasm in two leaps”, according to an unknown Polish economist quoted by Jeffrey Sachs). This is impractical, especially in a country the size of the Soviet Union, therefore the process has taken a couple of years. Any single step toward the reformed model is an improvement independently of its timing and sequential position. Parallel progress can be made on different fronts, naturally proceeding from where resistance is weakest, except when some stages naturally suggest themselves; for instance, ruble convertibility into foreign exchange will be realized first domestically, then within CMEA, then worldwide. The Abalkin Report recognizes that “We had no concept or theory of the transitional stage, no idea of the sequence of how to implement our reforms” and its envisaged stages of economic reform are no more than a bunching of measures according to increasing difficulty of implementation rather than a well reasoned sequence.

Ideological/political constraints, which are also responsible for this sequencing failure of economic reform in the Soviet Union and other countries, are, first and foremost, the traditional commitment to price stability and the fear that extensive and large price rises would not be socially acceptable; the rejection of a confiscatory replacement of the currency (converting wages, savings and cash at progressively worse rates than applied to the conversion of prices) because it might undermine the credibility of the government, and because of memories of similar operations undertaken after the last War in the USSR and Eastern Europe (as well as West Germany and many other countries in financial distress before and after); the commitment to egalitarianism and the reluctance to remove subsidies out of concern for adverse distributive effects.

## **Soviet Proposals for a Parallel Currency**

A peculiar feature of the Soviet approach, which is not present in any of the other reforming countries, is the idea that a parallel convertible currency might be introduced next to the ordinary ruble, first in selected areas and/or sectors and gradually pervade the whole economy, gradually and painlessly replacing the old inconvertible ruble. This approach is clearly rooted in the 1924–1926 NEP monetary stabilization based on the “chervonets” (equivalent to 10 pre-war gold rubles).

There are several versions of this particular approach. Viktor Belkin advocates issuing special rubles to enterprises producing (additional?)

consumption goods; those rubles would give an entitlement to deliveries of domestic and imported inputs outside the central allocation systems; they would spread from consumption to intermediate goods and investment industries; the positive supply response would allow the gradual withdrawal of the old rubles.

Wassily Leontief and George Soros, in a project discussed over the last year by several Soviet-Western working groups at the State Committee for Foreign Economic Relations, headed by Ivan Ivanov, advocate setting up an Open Sector, made up of non-state enterprises (private, cooperative, joint ventures) and state enterprises or their subsidiaries only after they have been duly "sanitized" (i.e., after they have shed surplus liquidity and have cut their access to easy money). The OS enterprises would use a convertible Valutny Ruble obtained through exports and loans, import freely, obtain any shortage domestic input at international prices, export freely and retain or sell freely all their export earnings; their activities, and especially relations with the rest of the economy, would be monitored by an OS Managing Authority; the reform of the Soviet economy would be achieved by the progressive expansion of the Open Sector (in the final version of this project the special currency has been replaced by the direct use of hard currencies, with a view to gradually making the ordinary ruble convertible). In the version preferred by the Soviet side the Open Sector has a territorial basis, i.e., it amounts to a set of Special Economic Zones instead of a sectoral (Belkin) or functional (Soros-Leontief) basis. The idea of a parallel currency was recently put forward also by Nikolai Petrakov, and is reiterated in the Abalkin report published by *Ekonomicheskaya Gazeta* in early November.

There is neither theoretical nor historical justification for suggesting a parallel convertible currency. Theoretically the case for it implicitly rests on the presumption that there is a positive supply response from economic reform which however is only available for a slow diffusion of reform measures via the growth of a parallel monetary circulation. Historically, the ruble stabilization via the introduction of *chervontsy* during NEP was accompanied by hyperinflation and the demise of the other ruble, the *sovznak*, and there is no reason to suppose that this would not happen again today.

## **The Primacy of Stabilization**

The single main step out of sequence in the Soviet reform process is the liberalization of some markets, especially foreign exchange, and the

decentralization of enterprise decisions, in conditions of persistent excess demand for most goods and of centrally fixed, upwardly rigid prices. Abel Aganbegyan puts the ruble overhang at rubles 150 bn, equivalent to about half of saving deposits or four months wages; the quantification of the overhang is a difficult task, since it requires information about the money in circulation (which is not available, probably also to the highest authorities) as well as estimates of demand for money, which are a matter of opinion. The detection of overhang, however, is impossible to miss; it is continuously fed by wage settlements (like that with the striking miners) not matched by available consumption, by large (in spite of systematic underestimate) budget deficits, rising from 18 bn rubles in 1985 to 90 bn last year and 120 bn this year (a fall to a 90 bn rubles deficit is planned for 1990, which is still absolutely and relatively large).

Obviously without the prior elimination of the ruble overhang – whether through inflation or stabilization – the entire excess liquidity will be thrown to each market that might be liberalized: the rate of exchange in free segments of the foreign exchange market will have nothing to do with either the preconditions of improving trade flows, or the relative purchasing power parities or any other notion of relative competitiveness; the exchange rate devaluations without the parallel reduction of demand absorption will worsen terms of trade not promote net exports; the persistence of excess demand in the regulated markets or market segments will either lead to random access to goods – which is unfair, disruptive and inefficient – or require the indefinite continuation of central controls, i.e., the indefinite postponement of radical reform. Paying peasants partly in foreign exchange simply acknowledges officially the debasing of the domestic currency and secures its further debasement; while talks of convertibility of any kind, before stabilization, are fatuous, not to say perverse.

There is no likely supply response large enough – if any – to stabilise the economy in the course of economic reform. The only instance of such a supply response are Chinese agriculture and, in the last year, the Vietnamese economy which is also largely agricultural; in general, on the contrary a temporary deterioration in current performance might be expected of economic reform, only later to be overcompensated by improvements. Reform is best seen as an investment – a good one, but still an investment. Market balance can only come from an injection of imports, or through demand reduction via taxes and bonds, or through price increases.

If a gap remains after supply and demand conditions have been improved, market balance cannot be achieved in a single round of price increases,

because the once and for all price increase that would eliminate excess money balances in the hands of the population and enterprises (stock equilibrium) is greater than that consistent with the balance of current incomes and real supplies (flow equilibrium); if prices are used to achieve balance then further rounds of compensatory increases – possibly through indexation of equilibrium real levels – are required to adjust flow equilibrium. The alternative to confiscatory currency reform (of the kind outlined above) is an inflationary spiral. In any case, the avoidance of hyperinflation on the current Polish scale (projected at 850 per cent in 1989) requires, prior to stabilisation, the adoption of strict monetary discipline (no more automatic credit) and the avoidance of budgetary deficits which would either be monetised upsetting monetary discipline or if funded through bonds add to the subsequent burden of public debt. Seeing that trends in real wages are the most important factor in determining enterprise demand for either credit or budgetary support, a prices and wages policy, agreed in a social pact between government and workers must be a necessary ingredient of the stabilisation package.

Sometimes it has been suggested that excess purchasing power should be mopped up by the privatization of state assets (as suggested by Soros and Sachs for Poland) or by the sale of bonds indexed either to a consumer index (as those issued in Poland in October 1989) or to the price of shortage durables (as suggested by Abel Aganbegyan). This alternative is better than persistent imbalance but can be extremely costly: given the state of uncertainty assets on average will be necessarily underpriced; while indexed loans may turn out to involve a monetary cost to the government far in excess of non-indexed loans, especially if – as recently in Poland – the flight out of the domestic currency is stopped by a combination of higher money interest rates (though still negative in real terms) and volatility of the free rate of exchange. A high and rising return obtainable on the appreciation of currency holdings, conversely, weakens the domestic currency further, as witnessed by the recent ruble devaluations.

If it is felt that the difficult and unpopular course of stabilization is not politically feasible then it should be recognized that radical reform is not possible, and all efforts should be concentrated instead on the elimination of the more glaring inefficiencies and on minor piecemeal improvements of traditional methods (i.e., on what used to be called “the continuous perfecting of methods of planned management”, as opposed to radical reform). However, the recent Polish experience shows that the ideological and political implications of what we have broadly labelled “sequential failure” can be

incommensurately greater than the ideological and political preoccupations that may have led to that failure.

## **Monopoly, Tutelage, Redistribution**

Once stabilization has been achieved it is possible to proceed with the unification of the price system, eliminating the two-tiers or many-tiers price regimes and bringing relative prices closer to opportunity costs in domestic production and in international trade, not by decree but through policies affecting the quantities supplied (i.e., through resource redeployment, capacity expansion and foreign trade). Autonomous enterprises, whose managers are chosen not for political merits but for their professional qualities can be expected to overcome the inertia of former central planning structures, i.e., to raise efficiency, adjust and innovate, and be rewarded or penalized according to enterprise performance.

Three major obstacles must be removed for this entrepreneurial function to arise. First, the monopoly power of large-scale specialized enterprises and their associations must be eliminated or at least reduced, not just through potential competition through international trade but through the fragmentation of large multi-plant units, an anti-trust regulation, and above all access to markets on the part of new small and medium scale enterprises.

Second, the link between enterprises and central administration must be severed – a link which implies their dependence through managerial appointments, salary scales and career structure, through allocations of scarce materials and foreign exchange, through negotiated incentives and disincentives, formal and informal pressure. One way of ensuring such independence is privatization, transforming state enterprises into joint stock companies whose shares are distributed or sold to employees, managers and other investors. This is not, however, the only possible way of severing the link between enterprises and central administration; the shares can be held by a State Property Fund, as envisaged in Hungary and Poland or, preferably, by a number of state holding companies (as in Algeria) and other institutional as well as private investors; enterprise capital can be leased rather than sold out. The danger should be noted of privatization without publicity and competition, resulting in divestiture rather than sale and in the parallel appropriation of state property by a few well informed people in position of power.

Third, the redistribution function of the state budget, subsidizing loss-making enterprises out of transfers from profitable ones, and compensating net revenue changes after the event, must be eliminated so as to reinstate the residual nature of profits as net revenue after contractual fixed payments. Markets have not only an allocative function and one of success verification, but also a much neglected function of forcing economic agents to live within their means under penalty of bankruptcy; the budgetary validation of enterprise losses removes this kind of financial discipline without which the sound budgetary policies advocated in the previous section are not implementable.

These three obstacles must be removed jointly, because the first and the other two are somewhat interlinked; for instance, monopoly power by firms makes a case for central control over price, supply and capacity expansion, as well as for some redistribution of possible monopoly profits. The removal of central control while maintaining monopoly positions is bound to involve a deterioration of market supply and economic efficiency.

## A Tentative Sequencing Pattern

There is no reason to suppose that just any step toward reform is an unambiguous improvement. Before a reformed structure can perform better than the old one the reform must be completed (a half finished railway takes nowhere) or at any rate it most probably has to reach a minimum critical mass. What is worse, some measures without others can be pernicious (e.g., enterprise autonomy without competition, foreign exchange liberalization without prior stabilization privatization without markets).

From the arguments developed above a tentative possible sequencing pattern emerges. First monetary restraint and budgetary discipline must be placed in position, strengthened by a wage and prices policy preferably enshrined in a social pact, with some indexation guaranteeing living standards stability in exchange for their moderation. Second, market clearing balance must be obtained in existing markets, whether through supply effects (presumed modest if any), net imports (possibly with international assistance) or the issue of bonds (non-indexed) without a premature privatization of state assets). Third, competitive conditions must be ensured, not only in the output markets but also in access of the existing capital stock, with compulsory surrender of assets by current users if others can employ those means more productively and bid more than them for their use. Fourth, the redistributive function of the state budget must be



abolished; the residual nature of entrepreneurial income must be guaranteed; enterprise and product subsidies are to be replaced by income subsidies to alleviate adverse distribution effects. Fifth, the hierarchical link between enterprises and central administration must be cut, through leasings, state holdings and privatization. Sixth, exposure to international trade signals and pressures, up to this point present but mediated through central planning structures, can be gradually increased; it is essential that the exchange rate should be unified, in order to avoid trade distortions which might result in very low (or even negative) value added of trade operations. Finally, some or even extended privatization might be considered, according to taste.

This proposed sequencing is not necessarily unique, let alone superior to all others, but is offered as a starting point for discussion. There is a presumption that partial and out-of-sequence reforms on a less-than-critical scale are bound to be and to have been not just ineffective, but actually damaging, not only because of the continued and possibly worsened waste of resources but also because they have made the task of radical reform all that much difficult to implement; they will have generated and diffused "false" signals both for quantities and prices, caused frustration and disillusionment of all economic agents; reduced the effectiveness of those measures already tried, misused and reversed, while the underlying imbalances have undergone cumulative growth over the time wasted attempting this partial, out-of-sequence and out-of-scale reform.

## The state of economic reform in Central-Eastern Europe.

	Bulgaria	Czechoslovakia	GDR	Hungary	Poland	Romania	USSR	Yugoslavia
Abolition of imperative planning	Discussed	In progress	In progress	Yes	Yes	No	Yes	Yes
Reduction in the number of Ministries	No	No	No	One ind. Min.	Yes	No	Discussed	Yes
Reduction of government contracts	No	No	No	Yes	One ind. Min.	No	1992-1995	Yes
Smaller scope of centrally fixed prices	Discussed	Discussed	Yes	Yes	Free prices	No	Small	Free & frozen
Laws promoting genuine cooperatives	Discussed	Discussed	No	No need	No need	no	Yes, important	Most firms
Laws promoting the private sector	Yes	Discussed	Yes	Yes	Yes	Yes	Individual	Yes
Laws promoting joint ventures	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Labor mobility	No	No	Yes!	Yes	Yes	No	Yes	Yes
Splitting of large enterprises	No	No	No	Discussed	Some	No	Discussed	Discussed
Anti-trust and competition laws	Discussed	No	No	Yes	Yes	No	No	Discussed
Unemployment-present	No	No	100,000	50,000	100,000	No	4 mn	13 percent
Unemployment-forecast	No	Some	More	100,000	1 mn	More	16 percent	
Sectoral restructuring	Not yet	Not yet	Not yet	Yes	Yes	Not yet	Yes	Yes
Stabilization program	Discussed	No	No	Yes	Yes	Expected	Inadequate	Yes
Privatization of state assets	No	No	No	Yes (1989)	Yes (1990)	Some land	Housing, leases	Discussed
Banking reform	Yes (1978)	No	No	Yes (1987)	Yes (1989)	No	Yes, limited	Not needed
Financial market for bonds and shares	No	Discussed	No	Yes (1987, 1990)	Yes (1989)	No	Bonds only	bonds only
Liquidation and bankruptcies	In theory	No	No	Yes	thin, de facto	No	Yes, rare	Yes
Foreign trade liberalization	No	No	No	Yes	Yes, limited	No	Licensing	Yes
Direct access to world market	No	No	Some	Yes	Yes	No	Yes, controlled	Yes
Hard currency auctions	Yes	One (VI-90)	No	Convertibility	No	Two (IX-89, I-90)	Convertibility	Yes

# Summary of Discussions\*

*C.M. Schneider*

Basically, the goal of a modern economic reform for most countries with previously planned or command type systems is to move to a market economy. There are two possible approaches which can be followed in order to achieve the desired effects:

- (1) the “big bang” approach (as exemplified by Poland) and
- (2) the “phased” approach.

The difficulty with the second type is the question of sequencing, because no historical precedent exists. When a number of alternatives are available, the *fundamental rule of transition* implies that the choice which promises to move the existing situation most convincingly toward a market economy system is the more desirable path to choose.

The primary question facing economists and policy-makers focuses on where to begin to treat the reform issue in a centrally planned economy as the Soviet Union. Is there a macroeconomics of a socialist economy? Near the top of the list of crucial issues when dealing with this topic are the institutions of the market place and their role in striving for economic stabilization. Naturally, a route must be chosen which speeds up the movement to a market economy. At the same time, central authorities should refrain from introducing additional regulation that impedes adjustments and growth. The macro-initiative includes studies to determine whether the economy in question is close to potential output or closer to a balanced situation in the short run. The principle characteristic of the Soviet economy is that the budget

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\*Comments made by William Nordhaus (USA), John Montias (USA), Sören Wibe (S), Benjamin Friedman (USA), Victor Bogatchov (USSR), Wolfgang Gerstenberger (FRG), Mario Nuti (I), Marton Tardos (H) and Ognyan Panov (BG).

is out of balance and a domestic currency overhang exists, which can produce inflation or aggravate repressed inflation. In addition, prices are out of alignment and there is an obvious lack of competition. Movement towards a market situation must be utilized to allow economic expansion, although such a path usually proves to be initially problematic and painful. The main tools that can be implemented to develop remedies for the present ill condition of not sufficiently demand oriented economies are monetary and fiscal policy.

The budget situation of a reforming economy is largely a flow problem. The immense detrimental effects incurred as a result of maintaining a budget deficit are often overemphasized. Experience proves that countries with relatively large budget deficits of up to 10 percent can do better than just survive, in fact, they can even thrive. The problems associated with such an attitude concentrate on the difficulty to find financing for a deficit and what to do with the obtained funds. If these are used for productive investments, then this policy alternative has a variety of benefits. If the deficit does increase, then policy-makers should attempt to refrain from implementing only quick-and-easy, short-run solutions such as simply printing money and, instead, look at the variety of alternative monetary methods. The lesson is to restructure the budget (i.e., by eliminating subsidies, etc.) in an attempt to attain macroeconomic stability. As a result of the loss of control of the budget, excess demand will emerge and incomes will become greater than GNP, while free prices will lead to product availability, though they may be too expensive to buy.

In cases of radical economic reform, it is important to renew both capital and money markets. This will entail the separation of central from commercial banking. Presently, the central bank of the USSR can supply some domestic and foreign currency, but due to the lack of a system of bank reserves there is no capacity to control the money supply. This also reflects the weak leverage to implement and enforce other monetary instruments. In fact, due to the ineffective system and the absence of appropriate statistics and methods of monitoring, the authorities cannot precisely say how much money is in circulation. The present trend and situation in the Soviet Union may direct policy more towards monetary reform rather than price reform, because the price reform would more negatively affect the population in the form of direct costs, opportunity costs and the like. Essentially, monetary policy cannot be left to be determined within the market.

Inflation is a further problem within the realm of economic stabilization, which is clearly close to the heart of most Eastern European reformers and

policy-makers. Stagflation, indexation, measurements and accounting have all been listed as sources of inflation in Eastern Europe. One of the keys to the reform is to achieve market clearing prices without inflation. Due to the fact that it is improbable that restructuring the economy can be successful in an inflationary environment, the inflationary pressures must be diffused. In order to achieve this, austerity, strict fiscal policy, tight monetary policy and a social pact on wages are required. The citizens must accept and agree with measures for any reform program to attain preferred results.

The fundamental problem, which is at the root of deteriorating economic life in countries traditionally bound to a command or planned economic framework, is associated with the inability to apply even simple economic principles. The relative roles of microeconomic (structural) and macroeconomic (stabilization) policies in the reform plans is of crucial importance. While the issues are reasonably critical on the micro-side (i.e. incentives, competitiveness and prices), the stabilization issues may be those that are more easily dealt with as long as they remain within the given structural framework. Of course, the links between the different areas of economic stabilization, such as between wages, monetary policy, and budget deficit, should not be neglected if a thorough reform is to be successful.

In summary, four areas of economic stabilization must be carefully analyzed and policies developed when attempting to proceed on the course of an economic reform from a command to a market system.

(1) *Banking and Monetary Reform*

This includes a number of subtopics like: institutions of central banking (instruments, appropriate policies in the near future, independence and autonomy), commercial banking (supervision, regulation, accounting), other government liabilities (bonds, etc.) and monetary "reform" (parallel currency, mandatory conversion). Both complete and decent statistics and data will be necessary to understand the existing situation and make appropriate policy decisions for the future.

(2) *Fiscal Policy, Taxation, Deficits*

Under this heading the main points to scrutinize are: the importance of budget discipline, the structure of the tax system (including the types of taxes, cyclical aspects and stabilization rules), roles of commodity subsidies relative to income transfers and the generally appropriate role of utilizing the budget relative to allowing market determination.

(3) *Anti-inflation Policy*

Here the main question revolves around the reasons for and the problems

of how to deal with open versus repressed inflation. Other important topics include: government tools available and utilized to deal with inflation (for example; fiscal, monetary, tax on wages fund, social and/or political support), indexation (how much, nominal versus real anchors and problems of the price-wage-price spiral) and social costs of anti-inflation policy (such as unemployment, budgetary problems).

(4) *Sequencing of Overall Stabilization*

In this case, the fundamental dilemma to be addressed deals with stabilization before structural change, or not. Structural change is associated with freeing prices, demonopolization, privatization, hard budget constraints and opening the economy. The question of whether to choose the "BIG BANG" or "GRADUALIZATION" as the transition method is also at the forefront of discussion. Finally, it is crucial to adjust the planning system to compensate for and adjust in the face of changes induced by the reform such as changes with respect to deposits, investment, wages, and so on.