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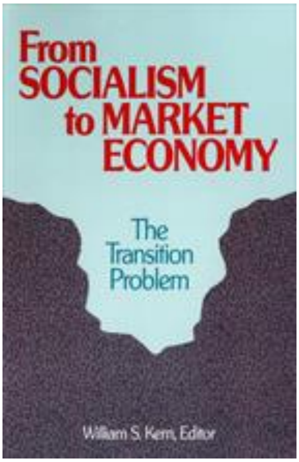

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Soviet Economic Reform
The Transition Problem

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The Basic Difficulty Facing the Soviet Economy

The fundamental issue facing Soviet economic reform today is the problem of transition from a centralized to a decentralized economic system. Even if the design for a new economic mechanism were perfect, the dominant problem would still be: how do you get there from here. This paper will focus on the issue of transition—its meaning and its consequences for the progress of Soviet economic reform.

It is important to note from the start that while there is abundant Western theory to help Soviet economists design a market system, there is no available theory of transition from a centralized arrangement of economic institutions to a decentralized one. Western economists have not been concerned with this issue, since the development of decentralized economic mechanisms in the West took place slowly over long periods of time spanning more than a century. And Soviet economists themselves have only recently begun to work on the issue. Previously it was not a subject of concern, since radical market-type reform itself was not openly discussed. Hence there are no theoretical guides, either Western or Soviet, that Soviet leaders and economists can draw upon as they attempt to deal with the problems of transition.

At the base of the transition problem is the interrelated nature of an economic system. One element of the system cannot be changed without changing other elements if true change in economic behavior is to be achieved. Thus, to give Soviet managers decisionmaking power over what they are to produce, they must also be given the power to decide what inputs they will use: materials, labor, and machinery.

First, if managers are to have the power to decide what materials they will use, the centralized system of material supply, introduced in the 1930s, has to be abolished and a system of wholesale trade put in its place. But given the widespread nature of material shortages in Soviet industry, there is a fear that the removal of the centralized materials rationing system will exacerbate these shortages and cause massive disequilibria in the economy. Supporters of reform, however, argue that the rationing system itself contributes to the appearance of shortages, because managers, operating within the administrative centralized supply system, order an excessive amount of inputs to protect themselves against the inefficiencies and uncertainties of the command system.

Second, Soviet managers have to be given increased power over the hiring and firing of workers. If managers are to be encouraged to seek out and adopt advanced technology in the pursuit of the reform's goal of economic modernization, they have to have the right to adjust their labor force to the quantity and quality levels appropriate to the new technology. This means giving managers the right not only to fire workers who are malingering, but also those who are working hard but who are made redundant by the new technology. Thus the extensive job security enjoyed by Soviet workers, especially during the Brezhnev period, will be diminished. But as many Soviet economists argue, the Soviet guarantee of full employment should guarantee the Soviet worker *a* job, not guarantee *his* job. Institutional arrangements will have to be expanded for handling unemployment and for the retraining and redistribution of labor.

Third, managers have to have the power to acquire the capital equipment that they decide they need. This again involves the abolition of the centralized system of materials and equipment supply and its replacement with a market system of wholesale trade. It also involves the question of investment and credit. If managers are to have the power to acquire capital equipment on their own, then they have to have access to the financial means to acquire this equipment. Moreover, to maintain the goal of decentralization, the banking institutions that decide on the allocation of investment credit must also be decentralized and should make their decisions upon the commercial creditworthiness of loan applicants rather than on any centralized investment plan.

If this freedom for Soviet managers to acquire the inputs they decide they need is not to lead to rampant inflation, their demands must be constrained. With the removal of centralized control over supplies and labor, the constraint that must be instituted is a hard budget constraint. That is, managers must be required to cover the cost of their inputs out of the revenues they earn. If they fail to do so, the process of bankruptcy must be enforced. Without the vulnerability to bankruptcy, the freeing-up of managerial decisionmaking will not work.

Furthermore, if managers are to make their own output and input decisions, independent of central planners, they will need meaningful signals with regard to economic costs and benefits so that the pursuit of profit will lead to the efficient use of resources. Otherwise, decentralized decisionmaking will lead to substantial inefficiency and waste. This means the Soviet price system will have to undergo radical reform. Not only will subsidies have to be removed, but the system for setting prices will have to be changed. Buyers and sellers must be given the right to negotiate their own prices in a free and flexible way so that prices adequately reflect the conditions of supply and demand in the economy.

The reform of the Soviet economy is, in essence, a monetization of economic transactions and decisionmaking. The target planning of the command system is to be replaced by producer and user decisionmaking involving magnitudes calibrated in monetary terms. Therefore, monetary stability becomes critical. Issues of macroeconomic policy and control—the size of the money supply and of the government deficit—become of great importance. If the required monetary control is not exercised and if reasonable monetary stability is not achieved and maintained before and along with the introduction of the reforms, then the resulting surge of inflation will seriously weaken or destroy the effectiveness of the reform.

Finally, the reforms described so far may not work in the absence of one further element, namely, competition. Without the introduction of competition, without buyers being given a choice among competing suppliers, decentralization may not lead to the meeting of customer demands, efficiency, and technological dynamism, but to monopoly and the danger of continued technological stagnation and price inflation. Therefore, an additional element of the required set of reforms may be the introduction of a Soviet antitrust policy.

What all of this means is that due to the interrelatedness of an economic system, a number of reforms must be introduced more or less simultaneously in order for economic reform to begin to have any effect. In other words, to get the rocket of economic reform off the launching pad, an initial bundle of simultaneous reforms is required. One of the aims of an economic theory and policy of transition should be the pursuit of "minimum simultaneity," i.e., the development of a minimum bundle of simultaneous reforms required to launch the economic reform. For if everything has to be done at once, then the introduction of a decentralizing reform would face overwhelming obstacles. Especially under conditions of extensive market disequilibria, an abrupt shift from a centralized system to a full price-profit-market-money system would produce chaos.

In the elaboration of a theory of transition, it is necessary that the destabilization produced by the introduction of institutional changes be constrained to a level that allows the economy to continue to function. Certainly this is a policy constraint demanded by political leaders. Officials at Gosplan and the economic ministries are criticized for continuing to operate in the old ways. But at the same time, they are held responsible for the performance of the economy. The only way these officials know how to carry out this responsibility is by means of the old planning and control methods.

The key problem here is that the leaders want reform, but they want to bring it about without acutely destabilizing the economy. The maintenance of some of the old forms of planning and control is necessary to prevent destabilization. Thus, the transition process initially involves the introduction of new forms alongside the old forms, rather than immediately in place of them, with the idea that the new forms are to grow and in time replace the old forms. This growth and replacement process is, however, not well understood. To what extent does the maintenance of old forms inhibit, or even prevent, the development and growth of new forms, and what is the nature of the replacement process if it does take place?

There is, in addition, another underlying tension in the politics-economics relationship. An effective economic mechanism is one that produces rapid adjustment to changing conditions, to changes in technology and changes in people's desires. But adjustment involves the pain of dislocation. It reduces people's security. It affects rewards and penalties and the distribution of income. A socialist system politicizes the allocation of pain. A capitalist market system tends to depoliticize it. Though people in all countries look to their governments for protection against pain, in socialist countries this feeling is particularly strong. Thus there is the danger that the political pressure for government protection and intervention will prevent the economy from adequately adjusting to change, thus inhibiting the progress of economic reform or limiting its effectiveness.

The Record of Reform

When Gorbachev came to power in March 1985, his initial economic program was focused on the re-invigoration, rather than the reform, of the economy. Gorbachev called for growth acceleration and economic modernization based upon sharp increases in investment directed toward machine building and energy, plus extensive changes in administrative and management personnel. It was not until June 1987 that discussion of serious economic reform began. At a meeting of the Central Committee of the Soviet Communist Party, a resolution calling for the radical restructuring of the Soviet economy was adopted. The resolution recognized that the interrelatedness of an economic system required a bundle of changes to be made for any real change in the functioning of the economy to result. It did not, however, appear to recognize the difficulties of transition that would be involved.

The June 1987 resolution was accompanied by a new law on the state enterprise. Together they formed a program which promised a substantial move toward economic decentralization. The program called for the virtual abolition of the annual state plan and its obligatory targets, significant independence of enterprise managers from control by the center and the industrial ministries, enterprise incentives based on the pursuit of profit and financial responsibility, flexibility in the payment and allocation of labor, and reform of prices and the system of price formation. The new system was to be in place by the beginning of the 1990s. Until then, some aspects of centralization were to be retained, e.g., the so-called "state production orders," which were obligatory for the enterprises to fulfill.

A year later, in June 1988, Gorbachev launched a radical political reform affecting both central and local governments. An elected congress of people's deputies was created, which in turn elected a president and a legislative parliament (Supreme Soviet). And local councils (soviets) were to be directly elected by the people. Gorbachev appears to have concluded that political reform is a necessary precondition for economic reform. In order for economic reform to succeed, decisionmakers must have the information they need to make decisions, and they must be free of arbitrary government intervention in carrying out their decisions. Leaders in government and in the economy must be accountable for the results of the actions they take. They must have credibility in the eyes of the people. Thus, *glasnost* and democratization are prerequisites for successful economic reform.

What can be said about the accomplishments of radical economic reform so far since its launching at the June 1987 meeting of the Central Committee of the Soviet Communist party? Clearly, little progress has been made. The reform is barely off the launching pad. And there are a number of highly serious and troublesome developments, in particular the growth of inflationary forces, the spreading shortages of consumer goods, and the recent decreasing levels of output. Indeed, a thick cloud of crisis hangs over the economy and the people's expectations for the future are bleak.

Among the major causes of the present situation, it can be argued, is first of all an initial lack of sufficient understanding and appreciation by Soviet economists and leaders of the macroeconomic factors involved in the transition to a decentralized economic mechanism. Wage inflation (and through it, price inflation) has been a direct function of money creation resulting from (1) the government deficit, which has been substantial (even when account is taken of the fact that in the Soviet Union most of the investment in the economy is on the government budget), and (2) enterprise managers' pressure to increase money wages far beyond increases in productivity, given the flexibility of the incentive wage system accompanying the reform. Much of the current problem of empty shelves and consumer goods shortages is demand-related, that is, a consequence of the sizable increases in money wages which would not have been possible except for the action of the printing presses bloating the supply of money and the growth of the monetary overhang in the economy.

There has also, however, been a slowdown in the growth of output. This has been a result of the fact that, while some of the glue of the old administrative-command methods of management that held the economy together has been removed, and new economic methods of management have not developed fast enough to replace it. The first element of the economic mechanism to be affected has been that of interenterprise flows of materials. The coordination mechanism in the economy has been seriously weakened leading to a slowing down of growth and, this year, an actual decrease in output.

A further critical flaw has been the failure to introduce price reform. The maintenance of below-market-clearing prices, often through the payment of subsidies, contributes to the government deficit and to the prevalence of goods shortages. And the maintenance of the centralized system of price setting means that prices are not flexible signals of the relationship between supply and demand.

Thus the simultaneity problem in the transition to a decentralized economic system has proved to be a formidable barrier to the progress of Soviet economic reform.

In light of the failure of economic reform to get started and the growing sense of crisis in the country, several important developments have occurred with regard both to increased understanding of the economic issues and the working out of proposed programs for economic reform, particularly for the handling of the issue of transition.

First there has been a growing understanding among Soviet economists of the principles and importance of macroeconomic policies. Fiscal and monetary policies are discussed in a clear and straightforward manner, with the stress placed on the role they will play in the reformed Soviet market economy, particularly their role in managing inflation. Much attention in the public discussion of economic reform has been given to the monetary overhang and to ways of stopping its growth and of decreasing it: taxing excessive increase in money wages, and sale of shares, bonds, and apartments to the public.

Another important development in economic discussions over the past year has been the increasing focus on property rights and the creation of new diverse nonstate property relations. "Destatization" has become a rallying cry. What is of great importance here is the growing perception that a profit incentive is not enough to give an enterprise manager the needed sense of responsibility for the economic assets under his control. An ownership relationship is also necessary. Ownership brings with it not only an interest in an increase in the flow of profit (income) but also an interest in an increase in the value of the property (wealth), which leads to the protection and nurturing of society's assets.

In addition to the progress in understanding economic issues, there have been two or three major programs for economic reform put forth in the last year, each with a strong focus on the transition issue.

First, there was a report issued in October 1989 by the State Commission on Economic Reform headed by the economist Abalkin, a Deputy Prime Minister in the Ryzhkov government. The report outlines a design for a future Soviet market economy and discusses in some detail the measures to be taken to move the Soviet economy through the transition from a centralized structure to a future decentralized market structure.

The vision of a reformed Soviet economy spelled out in the report goes far beyond that proposed in the resolution of June 1987. While that resolution was ambiguous about the extent to which the new system would be a market economy, the Abalkin report unambiguously envisions a market economy. It states that, on the basis of Soviet experience, there clearly is no reliable alternative to a market mechanism as a means of coordinating the action and interests of economic units. It goes on to state that the market is also the most democratic form of regulating economic activity. The Abalkin report makes clear that a market system contains an array of markets. In addition to goods markets (for both consumer goods and producer goods), it includes financial markets (markets for securities and a stock market) and labor markets.

The report stresses that in the reformed economy there will be many forms of property ownership: leasing and cooperatives, farmer and peasant property, joint-stock companies, corporations, joint-ventures, and private property (though private individual property will not be permitted to lead to the "exploitation of man by man"). The report also declares that the state should transfer the administration of the economic property that it retains to the workers' collectives on the basis of lease contracts.

According to the report, the financial sector, fiscal and monetary and banking institutions, should be thoroughly developed. And the state should exercise its influence on the economy through a wide assortment of economic means, fiscal and monetary policies, rather than administrative controls.

Finally, extensive attention is paid in the design of the reformed economy and (elsewhere in the report) to social guarantees for all members of society, including those with few skills.

A major part of the report is devoted to the issue of transition. Three possible approaches are discussed. What are termed the conservative and radical approaches are dismissed, the first because it will never produce any progress in reform and the second because it will lead to chaos. What is called the "radical-moderate" approach is the one preferred. In essence it is a step-by-step approach for preparing and then introducing a bundle of simultaneous reforms which include a well-developed set of government fiscal and monetary controls. These will be used to manage the inflation which is inevitable with the introduction of markets in an environment of shortages. Extensive attention in the report is also paid to the protection of the people in light of the painful adjustments required. This protection will help people adapt to a market system. Included here is the indexation of incomes and pensions. It is clearly aimed at reviving popular support for the economic reform and the movement to the market.

The report also sketches out a schedule for the transition to the reformed economic system. Four stages are described covering the periods 1990, 1991-1992, 1993-1995, and 1996-2000, by the end of which a new economic system will be established.

The report was discussed at a large conference of economists in November, where it was criticized from both the right and the left. Conservatives attacked the conversion of the Soviet economy to a market economy. And the radicals attacked what they considered to be the excessive protection of workers from the economic adjustments which they argued were necessary for the success of economic reform, i.e., the creation of a flexible, efficient, responsive economic mechanism.

In December, Prime Minister Ryzhkov stated that he supported the Abalkin program, but called for a two-year delay in its introduction, during which heavy centralized priority would be put on increasing the production of consumer goods to eradicate consumer shortages. This echo of the administrative-command approach was not well received. It was followed in May 1990 by a formal government plan put forth by Ryzhkov that was similar in some ways to the Abalkin program, but it called for beginning the transition to a market economy with an immediate (July 1990) doubling of basic food prices, coupled with indexing of wages and pensions. This was rejected by the Soviet parliament, and Ryzhkov and Abalkin were instructed to return in September with a revised program.

In the interim, dramatic changes were taking place in the Soviet political scene. Power was shifting from the Communist Party to the elected government bodies and from the Kremlin to the republics. In April 1990, Boris Yeltsin was elected president of the Russian republic. He made clear his intentions to assert Russian republic sovereignty over the economy of the Russian republic, and his intention to move the republic quickly—in 500 days—to a market economy. At the end of the Soviet Communist party congress in July, Yeltsin left the party, strengthening his position as an independent political force.

Gorbachev thus faced a serious challenge, particularly sharp in the economic sector. He responded with a compromising approach. A joint Gorbachev-Yeltsin working group was set up at the end of July, under the direction of the respected economist Shatalin, a member of Gorbachev's Presidential Council, with the task of drawing up a program for the transition to a market economy. The working group met during the month of August and at the beginning of September submitted a lengthy report, including drafts of over 20 laws, which comprised a program for the transition to a market economy in 500 days.

The essence of the Shatalin transition program was quite different from that of Ryzhkov and Abalkin. The heart of the program lay in the rapidity of the transition process, in the dominant role it gave to privatization and to stabilization, and in its recognition of the sovereignty of the republics as the foundation for the creation of an economic union.

The rapidity of the transition process was symbolized by the phrase "500 days." This timeframe was not to be taken literally, but it represented a commitment to move ahead resolutely with a tightly sequenced bundle of reforms, recognizing the simultaneity problem. Such a commitment was critical in establishing the credibility of the reform program, which in turn was so important for the program's success. Furthermore, the Shatalin group made clear that they were talking about the transition to a market system, not the full development of such a system. The latter, it was generally acknowledged, would take several decades.

Second, the transition to the market was to be built on the basis of privatization rather than on the decentralization of state enterprise management. Privatization was to proceed from the top (turning state enterprises into joint-stock companies) and from the bottom (helping private people to set up small and medium-sized firms, with credit and access to space and materials). Financial institutions necessary for privatization (stock markets, commodity exchanges, etc.) were to be set up.

Third, stabilization policies were to be introduced immediately. Investment financed through the state budget was to be cut sharply as were the defense and KGB budgets. Tight monetary policy was to be initiated. Monetary reform through confiscation was to be avoided. Rather, the monetary overhang was to be absorbed through the increased supply of consumer goods (production and imports) and sales to the public of apartments and a range of state assets. The prices of up to 150 basic consumer goods were to remain fixed for the entire period of one-and-one-half years. Reform of other prices was to start as soon as the stabilization program began to take hold.

The aim of the stabilization program was to make the ruble the accepted, totally fungible, legal tender throughout the Soviet Union. As some members of the Shatalin group put it, the aim was to make the ruble "real money."

The fourth key element in the approach of the Shatalin program was that it started with the recognition of the sovereignty of the republics, and it tried to create institutional arrangements that would encourage the republics to give up some of their sovereignty in order to share in the benefits of these arrangements. A good example of such an institution was the proposed central bank, which was designed along the lines of the American Federal Reserve System. The board of governors of the bank consisted of a chairman and representatives from each of the republics. Thus each republic that joined the system would have a voice in the setting of monetary policy for the entire economic union.

The battleground is now in the political arena. As the old economic, social, and political structures are being destroyed, and new structures are slow in developing, instability is increasing. To deal with the situation, it is necessary for Soviet political leaders, primarily Gorbachev and Yeltsin, to reach certain agreements. First, they must agree on the nature of the new Soviet political union and the level of sovereignty of the republics. Without this, the political power to implement economic reform is lost. And second, they must agree on a program of economic reform, one that addresses the major problems of transition—"minimum simultaneity," property rights, and macroeconomic balance. Two different approaches have already been proposed and more are possible. If they come to an agreement soon, then there is a chance that by the turn of the century the Soviet economy will look substantially different from what it was and is today, and will begin to show signs of becoming a market economy with economic, financial, and legal institutions resembling those of the advanced industrial nations.

If, on the other hand, there is great delay in the political acceptance and introduction of significant transition measures, then the disequilibria and instability in the economy will intensify and the reimposition of economic controls will be likely. Where this path will lead is not clear. It can be argued, however, that since recentralization will not solve the problems facing the Soviet economy, another cycle of economic reform will be initiated in five to ten years. In *perestroika* II, Soviet leaders and the Soviet people, with the experience they have gained, may be more successful in dealing with economic reform and its transition problems, and a Soviet market economy may begin to take shape toward the end of the first decade of the twenty-first century.