

PN-ABZ-620

RUSSIA'S STORMY PATH TO REFORM

Edited and Introduced by Robert Skidelsky

Will Russia's latest stabilization programme succeed?

Why did previous efforts fail?

Why did Communism collapse?

What is 'Mafia Capitalism'?

Will Russia break up?

How can the West help?

These and other issues of key importance in Russia's Election Year are debated by leading Western experts and Russian politicians including Richard Layard, Mancur Olson, Jeffrey Sachs, Robert Skidelsky, Boris Fedorov, Yegor Gaidar, Sergei Glaziev and Grigori Yavlinsky.



THE SOCIAL MARKET FOUNDATION

The Foundation's main activity is to commission and publish original papers by independent academic and other experts on key topics in the economic and social fields, with a view to stimulating public discussion on the performance of markets and the social framework within which they operate.

The Foundation is a registered charity and a company limited by guarantee. It is independent of any political party or group and is financed by the sales of publications and by voluntary donations from individuals, organisations and companies.

The views expressed in its publications are those of the authors and do not represent a corporate opinion of the Foundation.

Patrons

Viscount Chandos
Lord Flowers FRS
Rt Hon Lord Owen CH
David Sainsbury

Chairman

Professor Lord Skidelsky FBA

Members of the Advisory Council

Professor Nick Bosanquet	Professor John Kay
Sir Samuel Brittan	Alex de Mont
Evan Davis	Andrew Tyrie
Michael Fallon	John Willman
David Willetts MP	

Members of the Board

Nick Alexander
Alex de Mont
Christopher Stone

Acting Director

Roderick Nye

Editorial Consultant

Lord Kilmarnock

3

RUSSIA'S STORMY PATH TO REFORM
edited by Robert Skidelsky

© The Social Market Foundation
1995

C

First published in November 1995
by
The Social Market Foundation
20, Queen Anne's Gate
London SW1H 9AA
Tel: 0171-222 7060 Fax: 0171-222 0310

©The Social Market Foundation 1995

All Rights Reserved

CTE Paper No. 1

ISBN 1 874097 85 2

Cover design by Adrian Taylor

Printed in Great Britain by
Xenogamy plc
Suite 2, Westcombe House
7-9 Stafford Road, Wallington, Surrey SM6 9AN
Typesetting by Wimyk Enterprises

D

CONTENTS

Participants	iv
Preface and Acknowledgments	vii
Editor's Introduction	1
Greetings by James Norris	7
Chapter One. 'The Devolution of Power in Post-Communist Societies' by Mancur Olson	9
Chapter Two. Speeches: Gaidar, Sachs, Glaziev Panel Comment: Yavlinsky, Polishchuk General Discussion	43
Chapter Three. Speeches: Yavlinsky, Urnov, Mau Panel Comment: Fedorov, Ouliukaev General Discussion	61
Chapter Four. Speeches: Fedorov, Vasiliev Panel Comment: Gaidar, Glaziev General Discussion	85
Chapter Five. Speeches: Chubais, Livshits, Skidelsky Panel Comment: Layard General Discussion	101
Chapter Six. 'On the Future Cohesion of the Russian State' by Peter Murrell	119
Chapter Seven. 'The Collapse of Communism: the Political Economy Context' by Robert Skidelsky	129

Conference Participants

ANATOLY CHUBAIS is the First Deputy Prime Minister (in charge of the economy) and former Minister of Privatisation. He is the chairman of the Federal Commission on Securities and the Capital Market. He is also Russia's representative to the IMF and the World Bank.

BORIS FEDOROV was the Minister of Finance in 1990 and from 1993-4. He was the Deputy Prime Minister in charge of economic reform from December 1992 to January 1994. Since February 1994 he has been Chair of the Duma sub-committee on money and credit policy. He leads his own political bloc, *Forward Russia*.

YEGOR GAIDAR was the Minister of Economics from 1991-92, acting Prime Minister of Russia from June to December 1992 and First Deputy Prime Minister in 1993. He resigned from government in January 1994 and now leads *Russia's Democratic Choice*, the successor to *Russia's Choice*. He is head of the Institute of the Economies in Transition.

SERGEI GLAZIEV is the leader of the *Democratic Party*. He was formerly the Minister for Foreign Economic Relations before resigning in September 1993. He is currently Chairman of the State Duma's Committee on Economic Policy.

JAMES NORRIS is mission director of the Agency on International Development (USA).

CHARLES CADWELL is the Director of the IRIS Center and an attorney with an extensive record of involvement in economic policy making and antitrust law, both with the US government and in the private sector.

RICHARD LAYARD is the Director of the Centre for Economic Performance at the London School of Economics. He is also the founder of the Employment Institute.

ALEXANDER LIVSHITS is a Professor of Economics and chief economic advisor to the Russian President.

VLADIMIR MAU is a Deputy Chairman of the Institute of Economics in Transition and a Professor of Economics at Moscow's Higher School of Economics. A long-standing adviser to Yegor Gaidar, he is the author of many publications on the history of economic reform in Russia.

PETER MURRELL is a Professor of Economics at the University of Maryland, and a member of the Executive Committee of the Council of Soviet and East European Research. He has written extensively on economic transition.

MANCUR OLSON is the chairman of IRIS and a Professor of Economics at the University of Maryland. The author of *The Logic of Collective Action* and *The Rise and Decline of Nations*, he is also a former Vice-President of the American Association of Economists.

ALEXEI OULIUKAEV is a Deputy Director of the Institute for Economics in Transition. A former adviser to Yegor Gaidar, he holds a doctorate in economics from Moscow State University.

LEONID POLISHCHUK is a Professor of Economics and a Project Director and Research Associate with the IRIS Centre. He specialises in studies of institutional reform and economic behaviour of formerly communist nations.

JEFFREY SACHS is the Professor of International Trade at the University of Harvard. He has contributed to the design of economic reforms in Bolivia, Poland and the former Soviet Union. He has also served as a consultant to the IMF, the World Bank and the OECD.

ROBERT SKIDELSKY is Professor of Political Economy at the University of Warwick. He is Chairman of the Social Market Foundation and of its Centre for Transition Economies. He is the author of *The World After Communism* and a biographer of John Maynard Keynes.

MARK URNOV is the Head of the Analytical Administration of the Russian President.

SERGEI VASILIEV is Deputy Minister for the Economy and Deputy co-chair of the Chubais Committee.

GRIGORI YAVLINSKY is leader and co-founder of Yabloko. Formerly a Soviet Deputy Prime Minister and aide to Mikhail Gorbachev, he currently chairs the Centre for Economic and Political Research in Moscow.

Preface and Acknowledgments

The conference 'Russian Reforms: Established Interests and Practical Alternatives' was held at the Aerostar Hotel, Moscow from 13-15 April 1995. It was organised by the Center on Institutional Reform and the Informal Sector (IRIS) of the University of Maryland at College Park, the Institute of Economics in Transition, Moscow, and the Analytical Centre with the President of the Russian Federation. This edited edition of the proceedings has broadly followed the conference format, with the four sessions (divided into opening speeches, panel comments and general discussion) forming the central chapters, framed by Mancur Olson's introduction (chapter one) and the papers by Murrell and Skidelsky (chapters six and seven). The conference proceedings, held in both Russian and English, were recorded, and transcripts made, which were translated as appropriate for the English and Russian editions.

The translations were done by Nathalie Shelotchkova of the Social Market Foundation's Centre for Transition Economies.

The conference organisers would like to thank the US Agency for International Development for its generous financial assistance. Given the failing telephones, faxes and administrative chaos of post-communist Russia, organising the conference was an extraordinarily difficult task. The credit for doing so with such aplomb goes to Charles Cadwell, the Director of the IRIS Center and his associates Leonid Polishchuk and Sergei Tagor. Without these financial and administrative contributions, the conference would not have been possible — nor this volume of its proceedings.

Editor's Introduction

This is the first major paper from the Social Market Foundation's Centre for Transition Economies. It has been made possible by the generosity of IRIS, which provided a grant towards its publication. What follows is an edited version of a conference on Russian Reforms held in Moscow on 13-15 April 1995, and attended by leading Russian politicians and Western experts. Framed by a magisterial introduction by Mancur Olson and comparative perspectives offered by Peter Murrell and Robert Skidelsky, it offers a Western readership a unique insight into what Russia's own leaders are thinking and arguing about in the run-up to the critical parliamentary elections to be held on 17 December.

Professor Olson is best known for his two books, *The Logic of Collective Action* (1965) and *The Rise and Decline of Nations* (1982). These are searching enquiries into the causes of collective organisation and the consequences for economic and political health of the existence of different types of organised group. Using standard economic theory, Olson argued that members of a group who seek to maximise their personal welfare will not, in the absence of coercion, organise to achieve a good common to the group unless the organisation can offer them some benefit additional to the achievement of the group's goal. The reason is suggested by public goods theory: individuals will not buy goods whose benefits are collective since in that case they get the benefit irrespective of whether they pay the cost. Collective goods will therefore be undersupplied relative to demand unless people can be coerced to contribute, by the state through the tax system or by an organization able to impose or offer 'selective incentives' for joining — ranging all the way from intimidation to membership privileges. Exceptionally, an individual may supply a public good voluntarily if his personal gain from the good exceeds the total cost of providing it. This is one of the strands of the argument Olson develops in his Moscow paper.

The other is that groups with exclusive, or sectional, interests can be more easily organised than groups with inclusive, or general, interests. Producer groups are more numerous and effective than consumer groups. This means that, over time, society fills up with 'distributional coalitions' each pursuing sectional interests at the expense of the general interest. In such a society 'the incentive to produce is diminished, the incentive to seek a larger share of what is produced increases. The reward from pleasing those to whom we sell our goods or labour declines, while the reward for evading or exploiting

2 Skidelsky

regulations, politics, and bureaucracy...becomes greater'. Such a society is not rising, it is declining.

In his Moscow paper Olson applies these ideas to the rise and fall of the Soviet system. He considers what would happen if a Mafia chief took complete control over a region or a country — that is, became a 'stationary bandit'. The stationary bandit has a rational self-interest in providing 'public goods' like law and order to exclude rival predators. Moreover, he limits his own exactions to that amount needed to preserve his revenue stream over time. Olson extends this model of rational autocratic behaviour to cover the case of Stalin. He credits Stalin with having realised that by seizing the capital stock of the Soviet Union, using it for capital intensive investment, and controlling the wages fund he could obtain a larger slice of national output for his own purposes than any other autocrat in history had been able to do. He created a unique form of mobilisation economy. But it could not last. Soviet Communism decayed and collapsed because of the growth of resistance to the very high level of implicit taxation. As coercion weakened, 'distributional coalitions' started springing up everywhere to divert the autocrat's revenues to themselves. As the autocrat was the only property-owner, everyone had an incentive to steal, no one to guard, productive assets. The conspiring coterie of 'burglars' were too narrow to have any 'inclusive' or 'encompassing' interest in the well-being of the whole. Communism dissolved into congeries of robber barons formed to expropriate what the stationary bandit had stolen.

The inheritance of communism was thus a hypertrophied state, whose expenses far exceeded its revenues, and which lacked a functioning constitution, or any legal basis for, or by this time tradition of, private ownership and commercial activity. What emerged from the seizure of state assets by enterprise directors (thinly disguised by voucher privatisation) was a 'Mafia capitalism' based, in Sergei Glaziev's words, 'on theft of state and private property as well as corruption in the administrative distribution of resources'. At the end of the Gorbachev era, production went into a free fall and inflation sky rocketed. This uniquely appalling legacy explains the unique difficulties the former Soviet Union has experienced in adapting to the requirements of lawful market exchange. It was very much in the minds of all the Russian conference participants as they tried to analyse the failures of 'stabilisation policy' and the prospects for its future success.

What stabilisation ideally means is ending high inflation and restoring production. It would be nice if these two things could be done simultaneously or even by the same instrument. Unfortunately this is not so. The Soviet productive system was geared to fulfilling state orders.

President Yeltsin's first deputy prime minister, Yegor Gaidar, cancelled most of these orders early in 1992, because the Russian government could no longer pay for them. However, the legal and motivational basis for a market-driven productive system was not in place, so production went into a decline which has continued till now — at least in the traditional heavy industry and agricultural sectors. State expenditures were switched to supporting a semi-idle workforce in their places of work. Since the Russian government could not borrow on the domestic or international market, the budget deficit was largely financed by printing money. Russia's annual inflation rate was over 1000 per cent in 1992 and is still likely to be three digit this year.

All the main Russian participants agreed on the need to reduce the inflation rate; they disagreed on how much it could or should be reduced given the economic structure and the balance of political forces; and also on the nature of the linkages, as Gaidar put it, between 'the money supply, inflation...and...production'. Intertwined with this debate was the question of how much the state could or should do to restructure/restore the real economy; and there were also sharp disagreements on the prospects for the current stabilisation effort backed, for the first time, by the IMF. Two important threads running through the discussion concerned the role of corruption in causing the post-Soviet system to malfunction and a rather touching faith in the scientific status of economics, a legacy, perhaps, of the Marxist training of the Russian participants.

To get the full flavour and range of the discussion the reader must read the book. However, it is worth highlighting here three analytic positions on stabilisation which emerged during the conference, each one associated with a leading 'economist politician'. Each heads a political party represented in the Duma — Gaidar is the leader of Democratic Choice, Yavlinsky of Yabloko, and Glaziev of the Democratic Party of Russia. They have all been ministers in post-communist Russian governments.

Gaidar's position is relatively straightforward. He believes that high inflation is exclusively a monetary phenomenon, and can and should be lowered by reducing the rate of growth of the money supply. He believes that only by curtailing the flow of money to the ineffective sectors will industry be forced to restructure for market demand. He has argued — more clearly elsewhere — that the experience of other eastern European post-communist economies shows that growth automatically resumes when inflation has been reduced to a low figure. Thus the ending of high inflation is a necessary *and sufficient* condition for the resumption of growth. This position was put clearly by the economist Andrei Illarionov of

4 Skidelsky

the Institute of Economic Analysis in an intervention from the floor (pp. 93-94). For Gaidar the main tasks of government in the transition are to steady the money supply and provide and enforce property rights.

Yavlinsky subscribes to a mixture of 'cost-push' and 'structuralist' theories of inflation. Although he emphasises the monopolisation of the Russian economy as the main barrier to low inflation, he is talking not just — or perhaps mainly — about monopoly pricing but about the political power of state and former state enterprises to extract federal subsidies. This explains why all the previous attempts at reducing inflation by monetary methods have failed and why also the current attempt will not succeed. The only way to reduce the 'sustainable rate of inflation' (which Yavlinsky reckons to be in the order of 10 per cent a month) is to de-monopolise the Russian economy. Unlike Gaidar, he does not see free imports as an agent of demonopolisation and favours a single market of the whole former Soviet Union protected against Western goods. Since de-monopolisation takes time, it follows that the reduction in the rate of inflation will be a much more gradual process.

Glaziev's position may be labelled 'Keynesian-Communist'. He emphasises the shock to demand from the cancellation of state orders and reduction in real wages rather than the growth of the money supply. The money supply is excessive only in relation to an output which is 50 per cent of what it was in Soviet times. The way to conquer inflation is to build up output by a mixture of protectionism, subsidy, and large-scale state investment particularly in the high technology sectors in which he believes Russia enjoys a potential comparative advantage. Glaziev was the most gloomy of the three economist politicians. He believes the reforms have sacrificed the solid scientific-technical achievements of the Soviet era, which could have been the platform for high quality growth, degrading the Russian economy to the level of a Third World country, and in the process reducing life expectancy and slashing the birthrate.

The only comment I would make on these three recipes for stabilisation — and here I reveal my bias — is that the suggestions of Yavlinsky and Glaziev seem to presuppose much more authority and integrity (freedom from corruption) than the Russian state in fact possesses — what Vladimir Mau in his presentation called 'illusions'. On the last day of the conference Anatoly Chubais, currently First Deputy Prime Minister, gave a notably upbeat prognosis of the current stabilisation programme, which came into force in January of this year. Supporting this view is the optimistic assessment of political developments offered by Mark Urnov, head of the

President's Analytic Administration. The sceptic would say 'But they would, wouldn't they?'

What is presented in the following pages is an important part of the political debate on which the forthcoming Russian elections will be decided. Even through the translated and edited prose the personalities of the politicians emerge: Gaidar, cool and practical; Fedorov, rumbustious and rhetorical; Yavlinsky, more politician than economist; Glaziev, the intellectual administrator. Through Glaziev's interventions run a hurt at the decline of his country which is probably much more pervasive in Russia than was apparent in the conference. These men are among the leaders of the new Russia: leaders with whom we in the West can and must engage, and from whom we can learn.

*Robert Skidelsky
London, December 1995*

Greetings

by James Norris

From its outset in 1992, the US economic co-operation program in Russia has been small in relation to the vast size of the Russian economy.

It has not been a program of massive financial resource transfers — such as would have enabled Russia to greatly increase its imports.

Rather, what the US has principally offered has been the knowledge and expertise of people experienced in dealing with problems and opportunities of market economies and democratic systems — such as Russia is now creating.

One of the major emphases of the USAID for International Development Program in its first two years was the dramatic program of state enterprise privatization. Within a remarkably short period of time, the ownership of Russia's industrial structure and much of the service sector was completely transformed — with more than 40 million individual Russians gaining a tangible stake in the economy and the direct controlling link between the government and individual firms being broken.

We are proud of the role, however small, which USAID played in supporting this important phase of the transformation of the Russian economy.

Three areas of co-operation characterize our current program of support for continued economic restructuring in Russia:

First, we support efforts to develop the legal, regulatory and judicial framework needed to protect businesses and individuals from such disparate risks and problems as:

- ◆ Securities and property fraud. The Russian Federation's establishment of the securities and exchange committee and the self-regulatory organizations being established by brokers and dealers will contribute to more stable investment and will give both Russian and foreign investors the confidence they need.
- ◆ Unsound banks. By providing training to commercial bank staff and advisory services to bank managers as well as support to the central bank as it develops its supervisory capabilities, USAID hopes to contribute to strengthening the financial sector.

Previous Page Blank

- ◆ Inequitable and distortionary types of taxation. Adjusting the tax structure of a command economy to meet the demands of a market economy is not easy. Analytical and advisory experts with long experience in market economies can help Russian policy makers to make the key choices — between guaranteeing enough revenue for the state to meet its responsibilities and providing a tax system that will encourage private investment.
- ◆ Inadequate commercial laws and application. We see this as a problem of transition and provide advisory services and training in preparation and application of commercial laws suited to a market economy.

Secondly, we provide direct assistance to different private enterprises.

- ◆ To the now-privatized, formerly state-owned, enterprises our assistance takes the forms of commercial, financial and legal advisory services to assist the new joint stock companies restructure themselves.
- ◆ The burgeoning sector of new enterprises, often of a micro- or small-scale. This perhaps is the most exciting area of support because it is the most creative. Business incubators, equipment leasing programs, and other business services are being developed with USAID funds to support growing numbers of small businesses.
- ◆ A range of business and professional associations. As the experience of private sector operations grows within Russia, the technical advisory services which are now provided by expatriates will increasingly be provided by Russia themselves. By supporting the start-up of business and professional associations, we hope to accelerate this process.

Support for the development of key 'markets' is a third area toward which our assistance is focussed.

- ◆ Capital market development is clearly the counterpart to development of the regulatory framework for securities.
- ◆ Land market development is a natural counterpart to business development — as land is often the most valuable asset which new companies have.

I hope the ensuing discussions will provide guidance as to how these resources — human, intellectual, and financial — can best be mobilised and, particularly, what kind of legal, regulatory, and judicial framework will be most appropriate to that effort.

Chapter One. The Devolution of Power in Post-Communist Societies: Therapies for Corruption, Fragmentation and Economic Retardation

by Mancur Olson

Compare what happened after the defeat of fascism in World War II to the societies that had been under fascist dictatorships, with what has happened after the defeat of communism in the societies that had been under communist dictatorships. West Germany and Japan enjoyed economic miracles after World War II, but in many of the formerly communist societies economic performance is even worse than it was under communism. West Germany and Japan have also enjoyed a tranquil social order and their citizens have not been especially victimised by crime and official corruption,¹ but many citizens and firms in some formerly communist countries complain bitterly about mafias and corrupt officials. Post-war West Germany and Japan have shown no tendencies whatever to suffer geographical fragmentation or devolution, and Germany has even, after the collapse of the German Democratic Republic in 1989, seen a reunification. But several of the formerly communist countries — Yugoslavia, Czechoslovakia, and the Soviet Union — have broken into parts, and Russia has experienced not only some secessionism by Chechens, Tatars, and others, but also a devolution of power from Moscow to republics and other regional and local units of government. These extraordinary differences are all the more remarkable in view of the desires of the victorious countries in World War II. At the end of the war and for some time afterwards, the victorious countries were fearful that Germany and Japan would again emerge as aggressive dictatorships, so they did not want them to have either strong industrial economies or to become substantial and unified countries.

The dramatic contrast between the outcomes in the formerly fascist and the formerly communist societies has not previously been explained, I believe, because an idea or theory that is indispensable for a full understanding of the matter has not been available. We must have a deeper understanding of the ways in which post-communist societies function — better insight, as it were, into their social physiology — to obtain a correct diagnosis of the disease that sometimes keeps them from having economic miracles, from eliminating official corruption, and from conflict over political fragmentation. When we have the right diagnosis, the therapies that will cure the disease and allow the peoples of the post-communist countries to achieve their aspirations will be immediately evident.

Thus we must first develop the ideas or theory that we need to diagnose the disease. We shall then show that the theory illuminates a crucial feature of the experience of the formerly fascist countries and of other market democracies. We then extend the ideas to examine the ageing process of the type of political and economic system created by Stalin. An understanding of this process provides a new diagnosis of the pathologies of the transition from communism. We turn now to developing the ideas that we need.

A theory of power

What is needed here is a theory that focuses on coercive power and the gains from wielding it — on the incentive to acquire coercive power and the incentives facing those who have it. Any adequate intellectual framework must, of course, also encompass the market and the voluntary transactions in it, but (as we shall see) this is not the place to begin. Practical results depend not only on the incentives and self-interest of those with power, but also on their characters and morals and many other things. But the problem that confronts us will become impossibly complex if we do not take things one at a time. Thus I shall focus now only on the incentives — the inducements to self-interested action — that face those with power.

To make it obvious that I am focusing only on coercive power and analysing only self-interested behaviour, I shall use a *criminal* metaphor to start the analysis. Clearly, we cannot understand robbery as either a voluntary trade or a moral act, and thus it will help us focus only on the self-interested use of coercive power. With a precise focus, we will be able to see what is beneath the surface and to construct the needed theory. Since, in any successful society, criminal behaviour is the exception rather than the rule, the criminal metaphor will also remind us of the extent to which we are abstracting from the complexity of human nature.

Consider the incentives facing the individual criminal in a populous society. Other things being equal, a criminal is better off in a rich than in a poor society: there is more to steal. Theft also makes societies less prosperous than they would otherwise be — the time devoted to theft produces nothing, but it reduces the rewards from productive work and investment and induces a diversion of resources from production into guards, locks, police, courts and the like. Therefore, the crime committed by each criminal reduces the wealth of society and thus also the amount that is available to steal. Does the individual criminal curtail his crime because crime reduces the amount that is there to steal?

Everyone already knows that he does not, but it is important to see why. The typical individual thief in the society of, say, a million people, might bear something like one-millionth of the loss to society that occurs because his crime makes society's output less than it would otherwise be, but he alone is likely to bear the whole loss of whatever opportunities for theft he passes up. Thus the gain to criminals from a wealthy society and the fact that crime reduces society's wealth does *not* keep crime from paying — it is society's punishment of criminals and the efforts of individuals and firms to protect themselves that, sometimes, keeps crime from paying. Though each criminal does have a stake in the prosperity of society, that stake is so minuscule that the criminal ignores it.

As we shall see, it makes a great deal of difference whether individuals with coercive capacities have a tiny or 'narrow' stake in the society, on the one hand, or an 'encompassing' interest, on the other.

Now let us shift from the individual criminal to the head of a Mafia 'family', or other criminal gang that can monopolise crime in some neighbourhood. Suppose that in some well-defined turf, a criminal gang can not only steal more or less as it pleases, but also prevent anyone else from committing crime there. Obviously, the Mafia family has an incentive to keep other thieves out of its domain. Will it gain from stealing whatever it finds on its own ground?

Definitely not. If business in this domain is made unprofitable by theft, or migration away from the neighbourhood is prompted by crime, then the neighbourhood will not generate as much income and there will not be as much to steal. Indeed, the Mafia family with a true and continuing monopoly on crime in a neighbourhood *will not commit any robberies at all*. If it monopolises crime in the neighbourhood, it will gain from promoting business profitability and safe residential life there. Thus the secure Mafia family will maximise its take by selling 'protection' — both against the crime it would (if not paid) commit itself as well as that which would (if it did not keep other criminals out) be committed by others. Other things being equal, the better the community is as an environment for business and for living, the more the protection racket will bring in. Accordingly, if one family has total power to commit and monopolise crime, there is (apart from the protection racket) little or no crime. The considerable literature on monopolised crime makes it clear that secure monopolisation of crime does lead to protection rackets rather than ordinary crime, and that outbreaks of theft and violence in such environments are normally a sign that the controlling gang is losing its monopoly.²

The individual robber in a populous society obtains such a narrow or minute share of any loss or gain to society that he ignores the damage his robbery does to the society. By contrast, the Mafia family that monopolises crime in a community has, because of this monopoly, a moderately *encompassing* interest or stake in the income of that community, so it takes the interest of the community into account in using its coercive power.³ A gang with a secure monopoly over crime in the neighbourhood will be able to obtain a significant fraction of the total income of the community from its protection 'tax', and thus it bears a significant fraction of any social loss from robbery and burglary in its domain.

What would happen if the head of the Mafia family succeeds in taking complete control of some region or country?

The first blessing of the invisible hand

Part of the answer to this question came to me by chance when I was reading years ago about a Chinese warlord.⁴ In the 1920s, China was in large part under the control of various warlords. They were men who led some armed band with which they conquered territory and who then appointed themselves lord of that territory. They taxed the population heavily and pocketed much of the proceeds. The warlord Feng Yu-hsiang was noted for the exceptional extent to which he used his army for suppressing bandits and for his defeat of the relatively substantial army of the roving bandit, White Wolf. Apparently most people in Feng's domain found him to be preferable to the roving bandits. At first, this puzzled me: why should warlords who were stationary bandits continuously stealing from a given group of victims be preferred, by those victims, to roving bandits who soon departed? The warlords had no traditional legitimacy and had not been chosen by the population or by anyone else.

In fact, if a roving bandit settles down and takes his theft in the form of regular taxation, and at the same time maintains a monopoly on theft in his domain, then those from whom he exacts tax-theft will have an incentive to produce that they do not have if they will be picked clean by roving robbers. A stationary bandit will take only a part of income in taxes, because he will be able to exact more tax from his subjects if he leaves them with an incentive to generate more income. Thus the victims of the stationary bandit, like the bandit himself, will be better off than with roving banditry.

If the stationary bandit successfully monopolises theft in his domain, then his victims do not need to worry about theft by anyone other than the

stationary bandit. Since all of the settled bandit's victims are for him a source of tax payments, he also has an incentive to protect them.

With the monopolisation of theft, the victims of the theft can also expect to retain whatever capital they accumulate out of after-tax income and therefore they also have an incentive to save and to invest, thereby increasing their own future income and tax receipts for the stationary bandit.

In a world of roving banditry there is little or no incentive for anyone to produce or accumulate anything that may be stolen and thus little for bandits to steal. Bandit rationality accordingly induces the bandit leader to seize a given domain, to make himself the ruler of that domain, and to provide a peaceful order and other public goods for its inhabitants, thereby obtaining more in tax-theft than he could have obtained from migratory plunder.

Thus we have 'the first blessing of the invisible hand' — the rational, self-interested leader of a band of roving bandits is led, as though by an invisible hand, to settle down, to wear a crown, and to replace anarchy with government. The gigantic increase in output that normally arises from the provision of a peaceful order and other government goods gives the stationary bandit a far larger take than he could obtain if he did not provide government.

Since the stationary bandit takes a part of total production in the form of tax-theft, it will also pay him to provide other goods, besides a peaceful order, that the market will not provide. It is now widely understood that the market will not provide large populations with goods — such as flood control, quarantine against contagious disease or defence — whose benefits inevitably go to a broad population: the individual who strives to obtain such goods for himself will find that he reaps only a minute part of the benefits. Thus individuals and firms in the market will not have an incentive to obtain or provide a peaceful order or any other 'collective' or 'public' goods.⁵

But the rational stationary bandit will have such an incentive. He would reap a significant gain through increased tax receipts from any public goods that increased the productivity of the economy or the size of the population he controls.

The logic of narrow versus encompassing interests

With the model inspired by our criminal metaphor, we can see the precise and general logic behind the foregoing stories. As we recall, our individual criminal in a society of a million has only a narrow or minuscule interest in the prosperity of society which is not worth his while to take into account, and his interest is best served simply by taking all the cash in any till he robs.

The Mafia family that has the power to monopolise crime in a given neighbourhood, but not to keep the government tax collector out, will steer away from socially costly crimes like robbery and strive for a protection racket instead. In this protection racket it will not rationally demand everything in the till — it will not take 100% of all the assets a business or household possesses. This would lead to the failure or out-migration of the very businesses and households that the Mafia family, given the encompassing interest in the neighbourhood implied by its criminal monopoly there, hopes will thrive, thereby enabling absolutely larger protection tax payments. So the rational protection racket has a *less than 100 per cent* protection tax.⁶

The rational stationary bandit leader with secure autocratic power will not raise the percentage of his tax-theft beyond the point where the distortions due to this tax-theft reduce the society's total income so much that his *share* of this loss is as great as his gain from obtaining a larger percentage of the total. To see this, suppose there is a simple flat tax and that the tax rate that would maximise the tax-take for a given autocrat was exactly 50 per cent. Then the last dollar collected in taxes would reduce the national income by two dollars, and the autocrat would bear half of this loss, so he would be at a point of indifference, i.e., at the peak of his tax revenue function. More generally, the stationary bandit finds that he cannot gain from increasing the share, S , of the national income that he takes beyond the point where the national income goes down by $1/S$. The stationary bandit's encompassing interest in the society means that he is led, again as though by an invisible hand, to limit the rate of his theft.

This encompassing interest also makes him provide public goods. Specifically, he gains from using his resource to provide public goods up to the point where the national income increases by $1/S$ times as much as the marginal cost of the public goods. If his optimal tax rate is 50 per cent, he will gain from spending an extra dollar on public goods so long as that dollar adds two dollars or more to the income of his domain. A secure stationary bandit uses his power, in part, constructively.

Let us now consider a democracy under the control of a unified majority, and impartially assume that this majority has the same self-interest as the autocrat and redistributes income from the minority to itself. Since the members of the majority not only have the same control of the tax and transfer system as the autocrat, but also earn income in the market, they necessarily have a more encompassing interest than the autocrat. It follows that they will treat the minority better than the autocrat treats his subjects. This, in combination with some inherent reasons why there are superior individual rights to property and contract-enforcement in the long-run in lasting democracies, greatly strengthens the traditional case for democracy. But since these advantages of democracy are not necessary to the present argument and have been explained elsewhere,⁷ no more will be said of them here.

The anti-social or special-interest groups

Consider now situations where the firms or workers in an industry or the individuals employed in some occupation or some profession are organised to act collectively, as a lobby or a cartel. The firms or workers in any single industry or occupation are unlikely to be a majority of the electorate and unlikely to earn any substantial percentage of the national income of a country. Because they are not a majority they cannot obtain complete control of the taxation and spending power of a government. They must instead take advantage of the 'rational ignorance' of the electorate about the details of public policy and about their particular industry or occupation. They will then often through lobbying secure special-interest measures, such as protection against imports, regulations that limit entry and competition, tax loopholes or subsidies. They may also be able to cartelise or collude to obtain monopoly prices or wages in their market.

To what extent will the organisations for collective action that represent particular industries or occupations have an incentive to refrain from any redistribution to themselves that will do great damage to economic efficiency?

The profits and even the value-added in a typical industry and the wages in a typical craft or occupation are a small fraction of GDP. Suppose, for ease of calculation, that a given organised interest obtains exactly one per cent of the GDP. Then it will pay this organised interest to press for both governmental and cartelistic redistributions to itself up to the point where the social losses are 100 times as great as the amount it obtains: only then will its marginal share of these social losses be as great as its gain at the margin from further redistribution. Thus the typical special-interest group

has a very narrow rather than an encompassing interest. It therefore faces incentives that are by no means so wholesome as those facing majorities. Unfortunately, they are much more detrimental to society than those facing the secure stationary bandit, often also worse than those that face the gang with a protection racket, and not much better for society than those facing the individual criminal.

Those in particular industries and occupations are sometimes not organised for collective action. Collective action must overcome the free-rider problem. It can emerge only when the gains from organisation benefit just a small number of actors (like the few big firms in a concentrated industry) or when there are 'selective incentives' (rewards or punishments that, unlike the collective good the organisation provides its constituents, can be applied to or withheld from individuals depending on whether or not they contribute to the costs of collective action).⁸

Even when small numbers or potential selective incentives make organisations for collective action possible, it normally takes a long time before it occurs. Thus only long-stable societies have dense and powerful networks of organisations for collective action.

Testing the argument on the West

I have argued that it takes a long time for a society to accumulate many organisations for collective action, and that industry-specific and occupation-specific, and other narrow organisations for collective action, are more harmful to economic efficiency and dynamism. We can therefore test whether the theory fits the facts by looking at the experience of the market democracies of the West. If my theory is right, we should see that societies that set up a good legal order, after a catastrophe has destroyed organisations for collective action, will, for a time, grow extraordinarily rapidly. Similarly, long-stable societies ought to grow much less rapidly than societies that are in other respects comparable.

The society that has had the longest period of stability and immunity from invasion and institutional destruction is Great Britain. As the theory predicts, Great Britain also has had the 'British disease' — the poorest economic performance of the major developed democracies. The economic miracles of Germany and Japan after World War II are also consistent with the argument. With appropriate elaboration, the foregoing theory also explains the general pattern of regional growth in the United States since World War II, as well as other evidence.

The hidden sources of honest government and law-abiding behaviour

We do not yet have an explanation of why there has been an epidemic of complaints about official corruption and mafia crime after the defeat of communism, whereas there was no such epidemic after the defeat of fascism. Though they occasionally have suffered from notorious scandals, the citizens of West Germany and Japan — and of most of the other Western market democracies — have not complained nearly as much about official corruption and mafia gangs as many people in some formerly communist countries have. As has long been known, one source of law-abiding behaviour is a strong government that efficiently punishes illegal acts. West Germany and Japan, and most of the other major market democracies, appear to have had stronger government than Italy has had, and this helps explain why Italy, in its southern regions, has had major problems with mafia families when most of the other major market democracies have not. (Ethnic and racial division and the degree of elaboration of the legal right of defendants may also make a difference and help to account for the extraordinary levels of street crime in the large cities of the United States.)

But the strength of the government is by no means a sufficient explanation of the extent of crime and corruption, in part because we also need an independent explanation of official corruption. If government officials are corrupt, law breakers can buy immunity from prosecution and there cannot be a strong government combatting crime.

There is another source of law-abiding behaviour and honest government in most societies that seems to have escaped notice. This source of law-abiding behaviour and official integrity was missing under communism. To understand it, we must consider countries with market economies and good economic policies and institutions.

The self-interest of the individuals and firms in a market economy with good economic policies and clearly delineated property rights is a major force for crime prevention, lawful behaviour and law enforcement. Consider the prevention of theft or the maintenance of property rights (theft is of course taking something from someone who has a property right to it). The self-interest of the owners of goods leads them to guard against theft. In a society with private property, the self-interest of individuals and firms leads them to install locks, hide valuables, hire guards, and keep watch.

The self-interest of individuals and firms in the private sector also often helps the police, the courts, and the government generally in apprehending

and punishing theft. When a family or a firm is the victim of a theft, they normally help the police to apprehend the thief. Sometimes firms and individuals will even offer rewards for information that leads to the apprehension of criminals that prey upon them.

So, though the self-interest of criminals works everywhere to undermine the law, yet in a market economy with good institutions and economic policies there are always, on the other side, the victims and potential victims of crime who not only use locks, guards, watchfulness and a vast variety of behaviours to guard against theft, but who also pressure the police to recover stolen property and normally gladly assist the courts by testifying in trials against the offenders.

This obvious point about theft and property is only the tip of a large iceberg. Consider contract enforcement. Suppose that somebody has borrowed money but decided not to pay it back. The borrower, of course, does have an incentive to work against the enforcement of the agreement — i.e. the law that grows out of the contract that the two parties have signed. But the lender has exactly the opposite incentive. The lender will try to induce the borrower to pay the loan back by threatening his reputation and access to future credit and if necessary by getting the courts to seize the borrower's assets. In the case of theft, the victims and potential victims push the authorities to enforce the law and therefore offset the efforts of the violators.

Because lenders, in deciding to whom to lend, are picking the borrowers that they think are most likely to pay the loan back, a higher proportion of the loans will be paid back than if lenders did not exercise this judgment. That of course makes the paying back of loans more common and generates a habitual obedience to the private law that grows out of a mutually agreed contract.

Thus much law enforcement and law-abiding behaviour come about because the self-interest of the firms and individuals leads them to do what they can to avoid being victims and to assist the government's system of law enforcement. In societies with market economies and good economic policies and institutions, private firms and individuals do much more to discourage violation of the law and to help governments enforce the law than to undermine the law.

What about differences in the power and wealth of the people and firms in the private sector? Usually, in a successful market economy, the same inequalities in wealth and power that are, in other respects, a problem, help maintain law and order. When theft and the enforcement of contracts are

at issue, the more substantial and wealthier interests will normally be on the side of upholding the law. If the average burglar is not as prosperous, as well placed, or as politically influential as his victim, that means that the net force of the private sector is on the side of the law. If lenders are on average more influential than borrowers, this makes loan-contract enforcement work better. This not only works in favour of contract enforcement, but it also helps those who can gain from borrowing money by creating an environment where money can be borrowed on reasonable terms. The net private force in support of many laws is, I think, a matter of extraordinary importance.

Now let us look at countries that do not have good economic policies and institutions. Suppose that the government fixes prices and sets a price lower than the market-clearing price. If there is a price that is lower than the market-clearing price, the quantity demanded will be higher than the quantity that the suppliers, at that lower-than-market-clearing price, want to supply. So it will then be the case that there can be a *mutually advantageous trade* — one with two parties, a buyer and a seller, gaining — at a price that is higher than the controlled price and lower than the market-clearing price. Here is a situation in which *both parties* gain by violating the law — essentially all of the parts of the private sector act to undermine the law. The same thing holds true if the government sets a price above market clearing levels.

Suppose now that the government determines how much of some good will be produced, and that the quantity chosen by the planners is lower than the quantity that the market would have generated. There will then be some buyers who do not get as much as they would like and also some potential sellers who would profit from supplying these buyers at a price they are willing to pay. Both parties can gain from evading the law and, if necessary, corrupting the officials who are supposed to enforce it.

Now assume that it is ordained by the government that some good must be produced in excess of the amount that the market would dictate, or that some good must be produced which the market would not produce at all. There are then enormous costs that producers can escape if they do not produce this good or do not produce the prescribed amount of it, and (since the production is by stipulation uneconomic) the good is not worth nearly so much to buyers so they do not put up much of a fight for it.

The general point is that any legislation or regulation that is 'market contrary' must leave all or almost all parties with the incentive to evade the law and is likely to promote criminality and corruption in government.

Thus one reason why many societies have a lot of corruption in government is that they prescribe outcomes that all or almost all private parties have an incentive to avoid, and almost no one has an incentive to report violations to the authorities. When caught in violation of the rule, moreover, those on both sides of the market have the same incentive to persuade or bribe the policeman or government official not to enforce the law. Not only is the net incentive of the private sector to evade the law — essentially *all* of the private sector incentives are on the side of undermining the rules. With lots of market-contrary regulations, sooner or later the private sector — because everyone or almost everyone in it has an incentive to undermine or suborn its market-contrary actions — makes the government corrupt and ineffective.

The governments of the third world attempt to impose incomparably more market-contrary policies than do the governments of the prosperous market economies. As the foregoing argument predicts, they also have vastly more corruption in their governments. The huge informal economies in the third world are evidence not only of the extent of market-contrary policies, but also of the extent to which these policies have led over time to the corruption and ineffectiveness of third world governments.

As everyone knows, the communist regimes allowed very little in the way of private property. This meant that self-interest of the people in the communist countries was not brought to bear to prevent theft and to aid the government in apprehending and prosecuting theft. Market-contrary activity was, of course, also the norm in the communist countries. As many people who lived under communism testify, in the Soviet-type countries sometimes a factory manager could not even get his work done — could not fulfil his quota — without engaging a quasi-legal or illegal deals to obtain inputs. The whole system of Soviet-style planning was so market-contrary that even high officials — and perhaps especially high officials — had to violate the rules and the plan in order to comply with the orders and targets they were given. In other words, the market-contrary activity even often stood in the way of achieving some of the objectives of the regime.

We now have a part of the explanation of the chorus of complaints about crime and official corruption in the east, but only a part. As we shall see, we greatly understate the extent to which Soviet-type arrangements undermined law-abiding behaviour and the integrity of government officials by saying that the Soviet-type societies restricted private property and markets to an unprecedented degree. The type of system that Stalin initiated had a more fundamental feature that prompted even more illicit

activity and official corruption than could be accounted for by the foregoing argument.

It turns out that this additional corruption-inducing feature of the Soviet-type systems was, paradoxically, a side-effect of the very same thing that made the Soviet countries as powerful and imposing they were for a time. The same thing that made the Soviet Union a super-power also in the long-run corrupted it and accounted for its decline and ultimate collapse.

To understand what enabled Stalin to make his domain a super-power — and also led to its corruption, decline and collapse — we must return to the criminal metaphor with which we began, and especially to the theory of the autocrat as stationary bandit.

The theory of power extended to cover Stalinist regimes

The theory of autocracy earlier in the paper puts the spotlight on two reasons why the Soviet empire for a time offered both an economic and military challenge to the United States and its allies. Stalin's Soviet Union was an autocracy and therefore:

1. It was governed by an encompassing interest — the more productive the Soviet domain was, other things being equal, the more resources were available to achieve the autocrat's objectives, so Stalin had a powerful incentive to make his empire more productive, and
2. Stalin, as an autocrat, extracted the largest possible surplus from the society to increase his political power, military might and international influence.

Important as these two factors are, they do not explain why autocracies in the Stalinist pattern — i.e., what has come to be called the communist or Soviet pattern — were organised the way they were. Before Stalin consolidated his control over the Soviet political system at the end of the 1920s, no autocrat (not even Lenin) had organised his domain the way Stalin organised the Soviet Union. Why did Stalin impose on the Soviet Union (and later on the satellite countries) an economic system with almost universal state-ownership and the vast proportion of the prices and wages set by the regime?

The conventional assumption — that the choice for a centrally planned economy was because of Marxist-Leninist ideology — is inadequate. Saying the actions of autocrats are explained by their ideologies adds only a word

rather than an explanation unless we can, in turn, explain what inspired that ideology and why an autocrat chose that ideology.

After he obtained unchallenged power, Stalin adopted policies that he had previously opposed: total state absorption of the economy with brutal collectivisation of agriculture. Stalin was not a consistent adherent of any ideological position. Marx's writings also did not require the economic organisation that Stalin imposed. Marx had focused on capitalism and said almost nothing about the organisation of socialist or communist societies. In time, because of Stalin's practice and propaganda, Marxist-Leninist ideology came to be identified with the type of economic and political system he had imposed, but this later rationalisation cannot explain the choices Stalin made when he initially obtained dictatorial power.

Especially in view of the inadequacy of existing explanations of the special economic system in the communist autocracies, we need to extend the model of autocracy so that it can explain the special economic system in the communist autocracies and the special problems its collapse has bequeathed the societies in transition.

The limits on autocratic extraction

What limits the amount of resources that an autocrat can extract from his society? To answer this question, we must distinguish autocrats who have a secure hold on power and take a long-run view from those that do not. I argued earlier that a roving bandit leader, if he could secure and hold a given domain, had an incentive to become a public-good-providing king. When insecurity about how long he will be in power or anything else makes an autocrat take a short-term view, we must stand this logic on its head. An autocrat by definition has sovereign power and thus the power unilaterally to take any asset that he wants. If an autocratic ruler has a short-term view, he has an incentive, no matter how gigantic his empire or how exalted his lineage might be, to seize any asset whose total value exceeds the discounted present value of its tax yield over his short-term horizon. In other words, just as the roving bandit leader who can securely hold a domain has an incentive to make himself a king, so any autocrat with a short time horizon has an incentive to become, in effect, a roving bandit.

But, except in a special case, we will cover in a moment, a rational autocrat with a long time horizon will *not* confiscate the assets of his subjects because this will reduce investment and future income and therefore also his own long-run tax receipts. As was shown earlier, the rational autocrat chooses the revenue-maximising tax rate. Is there anything he can do

obtain still more? It *appears* that expropriation of capital goods, because it reduces future investment and income, cannot increase the tax receipts of an autocrat over the long run. But there is one way that it can, and Stalin was the first one to discover this way.

Confiscations that increase savings and investment

Stalin confiscated all of the farmland and natural resources of the Soviet Union, and all of the commercial and industrial property that had been privately held in the period of the New Economic Policy, and *the rate of savings and investment increased substantially*. In general, the Soviet Union after Stalin's innovations, and the other societies on which the Stalinist system was imposed, had far higher rates of savings and investment than most other societies. Stalin's innovation was to take almost the total natural and tangible capital stock of the country through a 100 per cent wealth tax, i.e., an expropriation, and then to use these resources to produce a mix of output that was much more intensive in capital goods, and other goods Stalin wanted, than would otherwise have been produced. By determining himself how much of the nation's resources would be used to produce consumer goods and keeping this proportion much smaller than it was in most other societies, Stalin gave the Soviet Union an extraordinarily high rate of capital accumulation at the same time that he augmented his annual tax receipts by an amount approximately equal to all non-labour income. In the long history of stationary banditry, no other autocrat seems to have managed this while at the same time greatly increasing savings, investment and the level of output.⁹

How taxes can increase the incentive to work

Stalin and his advisers also discovered a second innovative idea about how to increase the amount of resources he could obtain for his own purposes. Though most of Stalin's resources were obtained by taking all of the profits of state-owned enterprises rather than from explicit taxes on individuals, we must recognise that this was an *implicit* if inconspicuous form of taxation, and thus analyse it as a form of taxation.

We must also understand that, when an autocrat has *different tax schedules* for individuals of different productivities, he can collect much more tax revenue. In the typical modern democracy, high-income people confront higher tax rates or brackets than do low-income people, but everyone faces the same tax law or schedule. When everyone faces the same tax schedule, it is impossible to tax people more on their *first* hours of work than on their last or *marginal* hours of work and also to have very high tax rates.

Obviously, if each of us was taxed heavily on the first four hours a day of work, less on the next two, and not at all on hours after that, then we would have an incentive to work a lot more. We would have a stronger incentive to work because, if we were taxed heavily enough on the first few hours of work, we would be poorer and the 'income effect' of taxation would make us work more. If we were *not* taxed on our last hours of work, we would also have a greater post-tax reward for additional work, so there would be what Western economics calls a larger 'substitution effect', which would also make us work more than we would under ordinary Western types of taxation. Economic efficiency and the national income would also increase. So in some sense, the Western democracies would be more efficient and productive if somehow it were possible for their citizens to be taxed more on their first hours of work, but not taxed on their last or marginal hours of work.

But that is not a real possibility in a society with the same rule-of-law for everyone: then everyone must face the same tax law — that is, the same set of income tax brackets. Suppose that the United States decided to tax the *first* \$5,000 a person makes a year at 99 per cent, the next \$5,000 at 98 per cent etc., and to tax what each person makes in excess of, say, a million dollars at zero per cent. This method — reversing the progression and regressively taxing lower incomes at much higher rates than higher incomes — would create a situation where the least productive people would not have even enough income to survive. The productivity and efficiency-enhancing policy of taxing people more on their first hours of work — or, more generally, on their infra-marginal income — but not taxing their marginal income, is not only morally repugnant but also practically impossible when the same laws apply to everyone — when any society has the rule of law.

From each according to his ability, to the man in charge

There is, however, a way that a cunning autocrat can tax infra-marginal income at far higher rates than marginal income, and thereby obtain great increases in both tax collection and national output. Somehow, Stalin or someone from whom he borrowed the idea hit upon this method. Stalin was power-hungry and ruthless enough to put it into practice. The method is to set the salaries and wages of each occupation and ability level in the society with the purpose of collecting the maximum income for the autocrat's purposes from every individual in the economy.

First, Stalin had the subordinates he put in charge of the economy set wages and salaries *very low*, so people could not afford much leisure.

Second, he established a system of bonuses and of special rewards for people who were Stakhanovites or model workers. He also used *progressive* piece rates — that is, piece rates that increased the *per-unit* payment with the amount that the person produced. Stalin's combination of bonuses, progressive piece rates, prizes for Stakhanovites, and special perquisites for other especially productive workers was a system that provided people with a large proportion of the marginal output that they produced, but at the same time implicitly taxed them very highly indeed on their infra-marginal work.

In effect, Stalin's system of wage and salary setting had the effect of implicitly confronting individuals in different jobs or with different ability levels with a different tax schedule. This made it possible to impose higher average tax rates on the more able individuals who could produce a larger surplus over subsistence,¹⁰ while at the same time taxing the first hours of work severely and the last hours only lightly. To paraphrase an old saying, it was 'from each according to his ability, to the man in charge'.

The Stalinist regime obviously knew that it took more ability to be a factory manager than an unskilled factory worker, and it must have known roughly what ability and education level was appropriate for each major type of job. To motivate the more able people to take on the jobs needing more ability, Stalin made the total pay — including bonuses and other forms of marginal pay — for the jobs demanding higher ability higher than the total pay for the less demanding jobs.

Note that the familiar Western progressive income tax would not have served Stalin's purposes at all. Thus it is no coincidence that the Soviet Union, even as it attacked the market democracies for their inequalities of income, did not in any serious way use the progressive income tax. For a long time, the maximum rate of income tax in the Soviet Union, for example, was only 13 per cent.

As I mentioned above, and as Ronald McKinnon's important work on this subject explained earlier,¹¹ the main source of tax revenue for the Soviet-type societies was the profits of industrial enterprises (and turnover taxes that were, in effect, mainly taxes on the profits of these enterprises). Stalin not only claimed for the regime all of the profits of state enterprises, but also had his planners set infra-marginal wage rates and prices at level that would make industrial profits — and thus implicit taxes — very high.

The proportion of income in the Soviet Union in Stalin's time that was devoted to personal consumption of the population was lower than in any non-communist country, and that is exactly what the theory here predicts.

Stalin was able to obtain a larger proportion of the national output for his own purposes than any other government in history had been able to extract.

The origins of Stalin's innovative system of tax collection showed up most starkly in agriculture. The collective farm was designed to be 'collective' in the sense of 'collection', not as in 'collectivist'. After providing extensive labour services to the collective farm, the farmers were allowed to use any leisure time for work on the tiny private plots that were allocated to them. As the theory here predicts, the income from these plots was not, in general, taxed.

From Stalin's point of view the food collection system worked. During World War I the Tsarist state (even though at times it also used coercive measures to collect food) was not able to provide enough food to people in the cities to maintain its control: the February revolution began as a protest over the shortage of bread. By contrast, during World War II, the Soviet regime 'had at its disposal a well-developed procurement system ... Despite a disastrous fall in food production per head of the collective farm population, the share of total meat and grain output taken by the government rose'.¹²

Though Stalin was often considered the Pope of Marxist religion, he was not, in fact, a sincere ideologue. Though ideology no doubt played a role in explaining some of his support, the hypothesis here is that Stalin was not blinded by — or even faithful to — what had previously been called Marxism. If Stalin had been a committed ideologue he would not have done many of the things he did, such as killing off all of the people who had participated with him as initial leaders of the Bolshevik revolution, or purging those Bolsheviks who dared to defend their Marxist principles, or making the Nazi-Soviet pact. Stalin also did nothing whatever to bring about the withering of the state that Marx had predicted and advocated.

Yet he did a great deal to increase the size and power of the Soviet military and the industrial and scientific base that it required. Though the main features of the Stalinist system were not required by Marx's writing, nor by Lenin's example in the period of the somewhat market-oriented New Economic Policy, they are consistent with the hypothesis that Stalin wanted, above all else, the power that increased tax collections could give him.

A test: the ratio of power to income

If the theory offered here is true, the military or geo-political power and the expenditures on projects that add to the status and prestige of the political leader should have been greater, in relation to the standard of living of the population, than in other societies — even other autocratic societies. A casual glance at the historical record is enough to show that this was the case.

Tsarist Russia, though much the largest country on earth, was not able to give a good account of itself in the Crimean War. Nor was it able to defeat even the then-backward island society of Japan in 1904-5. Similarly, Chiang Kai-Shek's China, though it had the world's largest population, was militarily impotent.

Compare also Tsarist Russia in World War I with Stalin's USSR. In World War I the gigantic Empire of the Tsars was defeated essentially only by Germany,¹³ even though the German army had its hands full fighting on a second front against the French and British from the beginning of the war and normally used only a small fraction of its forces against Russia. By contrast, in World War II Stalin's Soviet Union was victorious against Nazi Germany, even though the Germans committed the great bulk of their fighting troops to the Soviet front: there was no 'second front' until the Normandy invasion in June of 1944. Though German ground and air munitions production was 2.6 times as large in World War II as in World War I, Soviet munitions production was 24.5 times as high in World War II as the Russian Empire's munitions production in World War I.¹⁴

Whatever interpretation may be offered for the fortunes of the different Russian autocracies in World Wars I and II, there can be no doubt that after World War II the Soviet Union was universally accorded a superpower status that the Tsarist autocracy never achieved and that the Tsars never managed a prestige coup comparable to the Soviet initiation of flight in space. When the Stalinist system was applied in China, Vietnam, and North Korea, it again made the communist autocracies incomparably more powerful militarily and politically than other third world regimes.

The inefficiency and decline of the Stalinist system

Having given the Stalinist devil its due, we must not forget the well-known point that the Soviet system, even at its best, was inefficient. The Soviet system mobilised a fantastic amount of resources, but it also wasted a lot. Stalin's confiscations eliminated many of the markets needed for an efficient economy. To obtain all of what would, in a market economy, have

been interest, rent, and profit, Stalin had to rule out private asset and rental markets for land and other natural resources and for capital goods. He also eliminated privately-owned firms, and society lost the gains from the innovations that private entrepreneurs would have undertaken. By setting wage and salary levels and differentials administratively in order to obtain colossal implicit tax collections out of labour income, Stalin also distorted labour markets, though by much less than expected because his taxation fell mainly on infra-marginal earnings. As a result of all of the eliminations and distortions of markets required by Stalin's confiscations and implicit taxes, the 'total factor productivity' (the output in relation to the inputs) of the Soviet-type societies was lower — and was growing less rapidly — than in market economies of comparable levels of development.

In the early years, the Soviet societies achieved rapid economic growth, in spite of their slow growth of total factor productivity, because they had extraordinary high rates of investment. These exceptional rates of saving and investment were, as I argued earlier, due in turn to the uniquely high proportion of national output that they could capture for investments that made them formidable and expanding competitors in the race for international influence and power. For about the first two decades after World War II, the societies that grew out of Stalin's innovations and conquests were able to make up for their inefficiency through their wondrous savings and investment rates.

We already know that, as time went on, the Soviet-type societies began to stagnate. Though they continued with their high saving and investment, they were after a time unable to obtain even moderate rates of growth of productivity,¹⁵ even though they still had a long way to go to catch up to Western levels.¹⁶

This is because the Soviet Union and the other countries on which the Stalinist model had been imposed suffered from a sclerosis analogous to the one that was described above when analyzing the market democracies and the 'British disease' of slow growth. But, for reasons that will soon be evident, the red sclerosis was far more severe than the form that afflicts the market democracies of the West. As time went on, the Soviet Union and (to a lesser extent) the societies that became communist only after World War II became severely sclerotic. Eventually this sclerosis reached fatal proportions and communism collapsed.

How could a system that served Stalin so well — that made him arguably the most powerful individual in the world — become so sclerotic that it could not, in the long run, even survive? This was not a question that

Stalin himself had to worry about. To paraphrase Keynes: In the long run, Stalin was dead.

But it is an overwhelming problem for the societies in transition from communism. As we shall see, the drop in income levels that most of these societies have endured and their continuing difficulties are mainly due to the sclerotic structures that continue to plague the societies in transition. So the 'red sclerosis' must be understood if the societies in transition are to find the therapy that will cure the disease from which they suffer.

How can there be sclerosis without freedom of organisation?

Obviously, the communist countries did not have freedom of organisation. It would be absurd to suppose that lobbying organisations of the kind that buy advertisements in the American media or labour unions such as those that have played such a large role in the United Kingdom could be responsible for their sclerosis. The red sclerosis was very different from that in societies with freedom of organisation, and not only because it reached the point of being fatal. It was also incomparably more discreet and subtle.

The key to the gradual decay of Stalin's system under his successors was its dependence on the decisions of subordinates in the bureaucracy. Though the role of markets in Soviet-type societies was much larger than is often supposed,¹⁷ the Stalinist system of implicit tax collection obviously had to limit markets more than any other societies have done. To maintain and increase investment after confiscating the capital stock, the Soviet-type regimes had to control consumption and saving decisions. After seizing all the tangible capital and natural resources in the society, there could be no private firms. If infra-marginal wages are to be set far below the free market levels, they cannot simply be left to the market. Thus a system of the type Stalin founded obviously must handle an awesome number of matters through its command and control system, and for this it had to rely on a vast army of nomenklatura and lesser administrators.

How could the leadership of a Soviet-type economy, given that it had to make through a bureaucracy millions of decisions that in other societies are governed mainly by markets, obtain an even faintly rational allocation of resources? That such a system would be insensitive to consumer demands and would also have major inefficiencies is so well-known that it should no longer need to be discussed. But how could it work well enough to create and sustain a superpower? I have explained how the encompassing interest of the Soviet dictator gave him a strong incentive to make his domain as productive as he could in the interest of increasing his total tax collections. We still need to explain how the autocrat was able to obtain the

information, plans, and implementation of decisions from his bureaucracy that were needed to obtain even a semi-coherent allocation of resources. Thus we face the extraordinary intellectual challenge of explaining how such a system could work at all.

Economists, operations researchers, and system analysts have, of course, long understood theoretically what would be needed for a fully efficient planned economy. The leader of a communist society would need to have enterprise managers and other subordinates estimate the input-output possibilities or 'production functions' of each and every enterprise and spell out the leader's goals or 'objective function' in great detail. In principle, economic planners could then calculate the optimal allocation of resources for the leader. The leader would have his subordinates impose this allocation. Since conditions and technologies are constantly changing, optimality requires that the whole process continually be redone.

As has long been known, a bureaucracy cannot obtain or process all of the information needed to calculate an optimal allocation or put it into practice. Of course, the communist countries did not need optimality to compete against their most imperfect competitors — they needed only a tolerable level of efficiency.

Obtaining the information needed for a coherent plan

For a Soviet-type economy to obtain tolerable efficiency — indeed, for it to function at all — the bureaucracy must centralise and utilise a staggering amount of information. The experience of actual conditions becomes evident only at the front line of the production processes and it is only there that the performance of most workers can be monitored. The information has to be passed up layer after layer of bureaucracy to the top. The orders worked out in the light of this information also have to be passed through all of those layers of officials on the way down. In any large bureaucracy, there is inevitably a large loss and distortion of information, even with the best efforts of all concerned.

For fundamental reasons, the best efforts of all concerned are not usually available. A manager's chances of promotion or bonuses are lowered if a superior learns of mistakes. Subordinates, therefore, have an incentive to hide all those shortcomings of their performance that can be successfully concealed from a superior. There is also an incentive to overstate the difficulties faced and to understate potential production. The more one reflects about these problems, the clearer it becomes that there must be a countervailing factor, or the centrally planned economies would not have been able to function at all.

Competition among bureaucrats

Competition among bureaucrats is such a countervailing factor. The strong incentive for production facing the leader of a Soviet-type society can at times be translated into tolerable performance because of the constraints on bureaucratic misrepresentation and negligence that arise because each bureaucrat or manager can be constrained and monitored by others. Suppose that a manager understates the output that can be produced with the inputs that are being allocated to him or that he produces much less than he could produce. Those managers who are given similar inputs and responsibilities then have an opportunity to make a good impression by promising or producing better outcomes.

The boss can also check with his subordinates' subordinates, and if there is unqualified competition among all the bureaucrats, the lower-level managers have an incentive to correct any erroneous information their superiors have given the boss in the hope of promotion and other rewards. Thus when there is bureaucratic competition among all administrators, each official must accordingly be cautious in under-reporting the potential productivity of the resources being allocated to him or in under-producing with the resources he is actually given. An astute superior can accordingly use competition among subordinates to exploit their more detailed knowledge and to draw out better estimates of potential production and better productivity than would otherwise be obtained. When there is full competition among subordinates, a leader can even allocate resources among his subordinates to those who make the best credible offers about how much output they will produce, so that, in effect, the resources are auctioned off to the subordinate managers who offer the highest 'bids' or output-to-input ratios.

Bureaucratic collusion

The foregoing argument assumed that collusion of subordinates does not limit bureaucratic competition or reduce the information or power available to the centre. For the early period of the Soviet-type economy (or a period after a purge, or a cultural revolution like the one Mao instigated, or other total shake-up of society), this is a fairly realistic assumption. But, as earlier parts of the paper argued, in stable environments, collusion and other types of collective action increase over time. This eliminates the competition among subordinates that is the dictator's only source of information about what is actually happening in the factories, farms, and other enterprises. It also means that he cannot, as it were, auction the productive inputs off to the managers who promise to produce the most

output, because managers will collude to offer less than they could have and then have surplus resources they can control themselves. Thus collusion or any kind of independent collective action among subordinates eliminates the competition that is the only thing that enables a Soviet-type economy to attain even modest degrees of productivity.

Subordinates have an incentive to collude at the expense of the centre if they are not caught and punished for doing so. If, for example, all the managers of the enterprises in a given industry understate how much they could produce with given amounts of inputs, they can keep a surplus that each of them can control. If they all offer less than they can when a superior 'auctions' inputs off to those who promise the greatest return, there is a surplus that they can keep. If the workers in a given setting collusively agree that they will only pretend to work, they are spared the effort that the foreman could have obtained from them had they remained in competition with one another. Such collusion is often feasible, since subordinates are the superior's main source of information about what is really possible.

The collusion normally begins at the level of the nomenklatura. There will normally be only a small number of factory managers in any given industry or locality. Because the numbers involved are small, the managers in a given industry can collude in much less time than would be required for a large group to coordinate action in its common interest. The restraints on independent organisation in a communist society — especially organisation that weakens the control of the leader — require inconspicuous, informal, and secret collusion, and the need to proceed covertly makes collective action emerge much more slowly than it otherwise would. But small groups can typically collude secretly and somewhat larger groups that have sufficient trust in one another can also manage this.

Thus, as time goes on in a Soviet-type society, there will be opportunities for many groups — especially small groups of high-ranking administrators and enterprise managers in particular industries — to organise informally and covertly. As more time passes, subordinates of subordinates organise. In due course this small group covert collusion can reach down even to coterries of senior workers in factories, mines, collective farms and retail shops. In the fullness of time, even big state enterprises, individual industries, and subordinate levels of governments will, in effect, become organised coalitions that can discreetly and subtly cooperate in their common interest at the expense of the dictatorial centre. Enterprises eventually become more nearly insider lobbies or organised special interests than productive enterprises. Ultimately even Republics in which language

and ethnic loyalties facilitate collective action can become conspiracies at the expense of the centre.

The foregoing accumulation of covert collective action would not be so damaging to the productivity of a Soviet-type society if each of the separate collusions, enterprises, and industry associations had a significant incentive to make the society work. But whereas the dictator or politburo at the centre has an encompassing interest in the productivity of the society, the separate collusions and special-interest organisations do not. Their incentives are quite as perverse as those of narrow organised special-interests in the market democracies, and nearly as perverse as those of the individual criminal.

Banding together against the bandit

We earlier discussed the way in which market-contrary policies undermine law-abiding behaviour and promote official corruption, because they create situations in which all of the parties involved have a common interest in evading the rules, keeping the evasion secret from the authorities, and corrupting the relevant officials. We know that the uniquely high rates of implicit tax collections in the systems of the Soviet type implied great interference with markets and that this encouraged corruption under communism. But this market-contrary character of the Soviet-type systems does not adequately convey communism's corruption-inducing tendencies. This can best be understood by going back to our stationary bandit metaphor.

It should not be astonishing if the subjects of a stationary bandit feel morally entitled to withhold income that a stationary bandit wants to tax, or to take back some of the income he has taken from them. Thus exploitative autocracies may not benefit much from the common feeling in successful democracies that individuals should not cheat on their tax returns, much less steal public property. Probably the Soviet-type regimes suffered some losses because many of their subjects recognised that they were exploited, but we must be careful not to exaggerate this factor. The populations of these societies were from childhood exposed to education and propaganda designed to make them believe in the regime and to uphold the norms it required. Obviously the media in these societies contained nothing analogous to the complaints about high taxation and waste in government that are commonplace in democracies.

The most remarkable corruption-inducing feature of the Soviet-type systems becomes evident when one compares this system of implicit tax collection with the traditional types of autocratic tax-theft. The autocrat

who leaves the productive assets and production of the society in the hands of his subjects has to fight tax evasion, but much of work of maintaining order is done by his subjects. Each subject tends to protect his property and this makes it possible for a traditional autocrat to keep theft among his subjects within bounds and also limits the exposure of his officials to bribery.

If, by contrast, an autocrat insists on obtaining 100 per cent of the rents, profit, and interest earned by the natural resources and tangible capital of his domain, and also sets the wages of workers in order to maximise the implicit tax on labour, then there is almost no private property or privately managed production. There is also *almost no property that subjects guard in their own self-interest*. Both the fixed assets and the inventory of every significant enterprise belong to the autocrat *and he is the only person who has an automatic incentive to guard this property*. In order to maximise implicit tax collections, almost all production has to be under the control of the autocrat and his subordinates and so every manager is in part a tax collector.

The autocrat then has more property and more tax collection than any man can watch. So there must be watchers and also those who watch the watchers. If those who watch best and collect the most for the center are rewarded and those who lose property and collect least are punished, the competition among the watchers and the collectors means that everyone is watched and all the collections are passed on: the watchers and collectors watch and collect from each other. Though they all would gain from overthrowing the stationary bandit and keeping his exactions from themselves, this overthrow would be a collective good for millions and no individual has an incentive to share the costs of obtaining it.

But within small groups, the autocrat's subjects can, when they eventually develop sufficient trust in one another, safely conspire together in their common interest. It is in their common interest to skim off part of the red bandit's take. Whenever any diversion of production, and theft of state property, or any failure to work conscientiously is observed only within the small conspiring group, it will not be detected by the centre. Whatever the autocrat cannot observe with his own eyes, he can learn about only through reports of those beneath him. Each individual in a small group will obtain a significant share of the yield of any collusion. So as time goes on more and more small groups explicitly or tacitly agree that they will do less work, allocate more of the resources under their control to their own purposes, and share more of the state property that they work with among themselves.

There are, however, limits to what any small group can take without being observed by someone outside the group. If the managers take too much, their subordinates may notice. If those in Department A take too much, those in Department B may be able to tell what is going on. So, if there is time for the manager and his subordinates, or Department A and Department B, to reach the point that they can trust each other with secrets, they can agree that more of the goods they produce and the assets they control will be kept for themselves. What happens in group after group and department after department becomes commonplace, and what becomes commonplace seems only natural and right. Eventually the enterprise, the industry, the locality, and even the ethnic or linguistic group come to agree, tacitly if not explicitly, that they can and should keep more for themselves. So as time goes on more and more of the central bandit's theft is taken back.

The centre has those who watch the watchers: the higher officials, party cadre, police, secret police and other watchdogs whose job is to ensure that none of the autocrat's property is stolen and that every enterprise, industry, locality, and ethno-linguistic group produces huge implicit tax collections for the centre. *But if no one except the centre owns property, and if no one except the centre has the legal right to claim the implicit tax receipts, then everyone except the centre has an incentive to induce these officials to become a part of the countless conspiracies to take back some of what the stationary bandit has stolen from them.* If the watchdog officials can persuade the centre they are doing a great job guarding the property and increasing the implicit tax collections of the centre, then they are likely to be rewarded. Even a small share of the gains from a diversion of production or the theft of assets is, however, likely to be worth more than the extra salary that comes from a promotion. The best outcome of all for the official is to be promoted and then take a share of the implicit tax collections and state property over a wider part of the economy. Of course, the centre has an interest in preventing this, but it has virtually no source of information on what is happening other than subordinate officials, all of whom have an interest in being part of a conspiracy to take back some of what the stationary bandit has stolen.

Ironically, it was Marx who coined the best phrase for describing a situation such as this. There is an 'internal contradiction' in any system of the kind Stalin created. In such a system, the autocrat takes most of the economy's output for his own purposes and owns almost everything. But this means that almost everyone else has an incentive to be part of collusions to take back some of what the stationary bandit has stolen. If all of the autocrat's subordinates simply compete with one another to receive the autocrat's

rewards and avoid his punishments, the system can work. But, in the fullness of time, as more and more coteries of subordinates collude in their own interests, the system not only loses efficiency and output but also becomes a web of counter-theft and corruption that ultimately leaves the centre impoverished. If the harshest punishments are imposed on even the faintest suspicion, then the bureaucratic competition that is indispensable to the system can be preserved somewhat longer, so Stalinist purges can make the system work better. In the long run, nonetheless, the difficulties of covert collective action are bound to be overcome in more and more enterprises, industries, localities and ethnic and linguistic groups. Thus it is a 'law of motion' of Soviet-type societies that they must not only run down over time, but also become increasingly corrupt. Ultimately, it becomes, some say, 'impossible to buy and easy to steal'. More and more victims of the regime come to believe that he who 'refrains from taking state property is robbing his family'. That is, part of the population comes to have a visceral, intuitive sense that they are the victims of an extraordinarily rapacious stationary bandit and that it is only right that they should take something back.

In a sense, the system becomes fairer as time goes on; the stationary bandit's take is shared more widely.

It becomes fairer, but it cannot work. The stationary bandit who takes everything except the minimum needed to elicit the effort of his captives has an *encompassing* interest in the productivity of the society, so he does what must be done to make the society productive and thus better able to meet his needs. By contrast, each of the conspiring coteries, enterprise lobbies, industry associations, and local societies obtains so little of the society's output that each of them has only a *narrow* interest, i.e., little or no incentive to maintain the productivity of the society. As communism devolved, it was bound to collapse.

The cures for corruption

Given the foregoing logic, there is nothing puzzling in the fact that Soviet-type regimes normally required state enterprises to make all payments through the state banking system and whenever possible tried to keep enterprises from using or holding currency — this facilitated extraction by the centre and made retention of profits by the enterprise more difficult. The multiplication of private firms after the collapse of communism means that there are more enterprises that use significant amounts of currency. These private firms are subject to extortion by mafia gangs in ways that state-owned enterprises without cash were not. This consideration has

probably helped make mafia-type crime increase in many countries after the collapse of communism. The disorganisation attendant upon the collapse of the old order has probably worked in the same direction. The emergence of a free press has greatly improved the reportage of crime and made it more visible.

Considerations such as these have made some people assume that the market economy, private property, and democracy promote corruption and crime. The emergence of democracy and the market economy opened the curtains and made crime more visible. They probably also created inviting new targets for criminals and corrupt officials.

If the logic in this paper is correct, it was the inevitable devolution of the extractive system created by Stalin that is mainly responsible for the corruption and crime that many citizens of the post-communist societies are complaining about. The advance of the market economies in the late 19th century was in most Western countries associated with the development of meritocratic civil services and higher standards of honesty in government than had prevailed in prior centuries. The rapidly growing market economies in West Germany and Japan after the defeat of fascism do not appear to have promoted crime and corruption.

When we take account of the ways in which the self-interest of the owners of private property makes them work to protect their property we see that a shift to private property tends to reduce theft. With private property, moreover, the net effect of the private sector incentives is normally to assist and encourage governmental efforts to combat theft. When there are market-contrary regulations, by contrast, those on both sides of the market gain from evading the law and cooperating to suborn the officials who enforce it.

Thus the diagnosis of corruption in this paper has strong and immediate implications about the therapy needed to cure the disease. One implication is that regulations, such those that limit the export or control the price of oil and gas, which run against the incentives in the market, promote corruption. They create situations where all parties gain from evading the regulation and, when necessary, sharing the gains with officials who are supposed to enforce the regulation. To reduce corruption and crime, a country should have no government interventions in the market beyond those that meet both of the following conditions: 1) they are directed at what Western neoclassical economics defines as 'market failures', and 2) the existing government, taking its shortcomings and the lobbying pressure that will be brought to bear on it into account, will come closer to

generating a socially efficient and equitable outcome than the imperfect market.

Another practical implication is that the sooner the last vestiges of the extractive system Stalin created are eliminated, the less the dangers of crime and, especially, official corruption.

The foregoing diagnosis of the problem of corruption does not, however, imply that all that a society needs to do is 'to let capitalism happen'. In fact, corruption and crime cannot be properly controlled and a country's economic potential realised unless the government effectively performs a role that the private sector cannot perform. Some enthusiasts for markets, at least in the West, suppose that the only problem is that governments get in the way of the market and that private property is a natural and spontaneous creation. This view is unquestionably and drastically wrong. Though individuals may have possessions without government, the way a dog possesses a bone, *there is no private property without government*. Property is a governmentally protected claim on an asset — a bundle of rights enforceable in courts backed by the coercive power of government. The governments of the societies in transition have to perform the gigantic task of making and enforcing general rules that define property rights, providing for the impartial adjudication of disputes about ownership of property, and of cutting back drastically the domain in which the administrative discretion of government officials can affect the value of property and contract rights. Better property and contract rights in the post-communist countries will not only help the economy immeasurably, but also mean that assets will be held by individuals and firms who have a secure and precisely defined interest in protecting them, and that will reduce corruption and crime.

The fragmentation of governments

The same red sclerosis that increased corruption in the communist societies also increased ethno-linguistic separatism and the devolution of power to regional and local governments. When the centre is a system of extraction, it is only natural to want to escape it. To the extent that a group had a distinctive ethnic loyalty or language, it was better able to conspire and collude against the huge implicit taxes imposed by the centre. Ethnic grievances and mutual trust within the group facilitate cooperation, and a separate language reduces the chances that the centre will learn of a collusive discussion. This is one of several reasons why, though there was virtually no separatism resulting from the defeat of fascism, formerly communist countries like Yugoslavia, Czechoslovakia, and the USSR have

broken down, and why there is separatism and devolution in various regions and localities of Russia.

Since it is impossible to alter the past, the fissiparous tendencies must be recognised as realities that can only disappear as a result of mutually advantageous voluntary interaction in future years. The experience of various customs unions like the Common Market in Europe and the North American Free Trade Area suggest that the gains from freer trade and outside investment in an area can be obtained without political integration. The exceptional prosperity of federalisms like Germany, the United States, and (especially) multi-lingual Switzerland suggest that large amounts of local governmental autonomy usually increase the efficiency and responsiveness of governments.

From economic retardation to economic miracles

The most important effect of the covert collusions that emerged in Soviet-type economies was probably not their impact on corruption and the desire for political separatism, but their drag on economic growth. We recall that a Soviet-type system was dependent upon competition among subordinate officials both for information and for incentives for performance. Subordinate officials had an incentive covertly to collude to reduce the competitive pressures they imposed upon one another and to obtain surpluses that they could control. As time goes on there is additional covert collective action and eventually state enterprises and industry associations become powerful insider lobbies. Each insider lobby is a narrow rather than an encompassing interest and has virtually no incentive to care about the prosperity of the society. Because of this, the lack of information at the centre, and the paucity of market incentives, the state enterprises in the later and more sclerotic phases of communism were often extraordinarily inefficient. Some large state enterprises were so uneconomic that the value of the material inputs they used, when properly valued at world prices, exceeded the free market value of the outputs they produced. The size and the hierarchical character of these enterprises nonetheless meant that they had formidable lobbying power.

With the collapse of communism and the advent of democracy, the big state enterprises and industry associations could lobby openly for protection against imports, for other forms of government subsidies, and for nearly free loans and inter-enterprise credits that were ultimately financed by the creation of new money by the central bank. The relative political power of dinosaur enterprises was all the greater because newly created firms had not usually had the time to overcome the difficulties of collective action and

were therefore unorganised. This meant the lobbying power in societies in transition is disproportionately held by precisely those enterprises that, in vast number of cases, need to be replaced by new or foreign firms. This has greatly slowed down the adaptation and transformation of the formerly communist economies. The subsidised credits obtained by these firms have also been the main source of inflation in most of the societies in transition. Privatisation can substantially reduce the lobbying power of these firms by denying them their insider status, but it by no means eliminates it.

As earlier parts of this paper showed, the economic miracles in West Germany and Japan after the defeat of fascism owed a great deal to the fact that fascist governments and allied occupiers had largely eliminated their lobbies and cartels. After the defeat of communism, by contrast, the societies in transition from communism were dense with powerful lobbies of the large enterprises and industry associations inherited from the old regime. Red sclerosis had bequeathed to these societies an especially virulent form of the 'British disease'. I believe that this is one of the most important reasons why economic performance has sometimes been even worse after communism was abandoned.

The therapy for this disease is easy to explain but difficult to implement. Each special-interest body, even if it consists of a gigantic firm or a major industry association, represents only a small minority of the population. Thus it will easily be outvoted whenever it demands special-interest favours if the public understands the matter. Indeed, most of the special-interests represent such a small part of the electorate that they are outnumbered even by the intelligentsia — even by that part of the population that does a lot of reading and is especially interested in public affairs. It follows that, if a better understanding of this problem and of western economics emerges in the societies in transition, the problem will largely be solved. It is not an easy thing to change public opinion, or even to obtain a more enlightened intelligentsia, but progress can be made, even through activities like the present conference. If there is enough of this progress, we can be confident that economic miracles akin to those that followed the defeat of fascism will follow in the post-communist societies.

Notes and References

¹ Though Japan has lately suffered from corruption by some of its best-known politicians, Japanese society has far lower crime rates than most other countries, and its bureaucracy is relatively honest. Except in certain areas such as construction of public works, most Japanese individuals and firms can go about their work without being troubled by corruption.

-
- ² See, for example, Diego Gambetta, *The Sicilian Mafia* (Cambridge, MA: Harvard U. Press, 1993)
- ³ For the concepts of encompassing or narrow interests, see my *Rise and Decline of Nation* (New Haven, CT: Yale University Press, 1982.)
- ⁴ James E. Sheridan, *Chinese Warlord: The Career of Feng Yu-hsiang* (Stanford, CA: Stanford University Press, 1966)
- ⁵ Since this reasoning is set out fully in my *Logic of Collective Action*, (Cambridge: Harvard University Press, 1965), I will say no more about it here.
- ⁶ If there is both a Mafia family and a maximising autocrat extracting resources, the combined protection-racket tax plus autocrat's tax will be higher than if only one of them had been taxing. When the Mafia leader, for example, is deciding on the protection-racket charge and is aware that activity in the neighbourhood is curtailed by the protection charge, he notes that some of the loss takes the form of lower governmental tax collections, and the Mafia family has no incentive to take this loss into account in deciding on the rate of protection payment it demands. If a Mafia family were, like our bandit gang that settles down, strong enough so that its protection-racket charge was the only tax, then the aggregate tax rate imposed on citizens would be lower and the income of the neighbourhood would be higher. In other words, *competition* among autocratic rulers for power over the same domain is bad for the subjects and *monopoly* by a single ruler is better for them. By contrast, competition in a democracy between two parties to obtain a majority that gives the winning party a term during which it has a monopoly of government means a significantly lower tax rate than under a single autocrat, and a much lower tax rate than results from a stationary bandit plus a Mafia family.
- ⁷ In my 'Dictatorship, Democracy and Development', *American Political Science Review* (September 1994) and formal proofs and additional results are provided in Martin McGuire and Mancur Olson, 'The Economics of Autocracy and Majority Rule: The Hidden Hand and the Use of Force' (IRIS, Working Paper # 127, August 1994)
- ⁸ The argument in this and the immediately preceding paragraphs are developed in my *Rise and Decline of Nations* and my *Logic of Collective Action*.
- ⁹ In the very short run, just after the collectivisation of agriculture and other productive assets, there was apparently a period of 'indigestion' and confusion when output may have significantly declined. But for most of the rest of Stalin's reign, the output that Stalin cared about was far higher than it had been before he imposed Stalinisation on the USSR.
- ¹⁰ I am grateful to James Buchanan for pointing out to me, at a very early stage of my work on the hypothesis that Stalinism was fundamentally a tax-collection system, that a communist tax-maximising system would not only try to raise the ratio of infra-marginal to marginal taxes, but also try to take more taxation from those who were more productive.
- ¹¹ See McKinnon's 'Taxation, Money and Credit in a Liberalising Socialist Economy', in Christopher Clague and G. Rauser, eds. *The Emergence of Market*

Economies in Eastern Europe (Blackwell, 1992), an IRIS publication also available in Russian translation published by the Foundation For Economic Literacy in Moscow.

- ¹² Peter Gatrell and Mark Harrison, 'The Russian and Soviet Economies in Two World Wars: A Comparative View', *The Economic History Review*, XLVI (August 1993), p. 444.
- ¹³ The army of the Austro-Hungarian Empire was also used against Tsarist Russia, but this army was often said to be poorer than that of any other combatant country in World War I, and it did not play an impressive role in the defeat of Russia.
- ¹⁴ Gatrell and Harrison, Table 9 and pp. 425-52. Gatrell and Harrison point out that 'In World War I ... only Germany's failure to disentangle itself from the Western front prevented the speedy victory over Russia which Germany intended. Even so, a small fraction of Germany's military power was able eventually to bring about Russia's defeat and disintegration. In the second war ... the scale of Soviet mobilisation, when combined with overwhelming economic superiority of the Allies, was sufficient to destroy Germany completely as a military power ... the USSR made a contribution ... that was disproportionate to the size and level of development of the Soviet economy' (p. 438)
- ¹⁵ See William Easterly and Stanley Fischer, 'The Soviet Economic Decline: Historical and Republican Data', (manuscript, 1993)
- ¹⁶ Peter Murrell and Mancur Olson, 'The Devolution of Centrally Planned Economies', *Journal of Comparative Economics*, vol. 15 (1991), pp. 239-265.
- ¹⁷ Because it is impossible for any bureaucracy to make decisions about all of the countless goods and services produced in a vast economy, innumerable decisions were in fact left for negotiations and contracts among state enterprises and to diverse legal, informal, and black markets.

Chapter Two. Speeches: Gaidar, Sachs, Glaziev

Yegor Gaidar

The point of difference between post-socialist and post-fascist regimes seems to me to be as follows. Post-fascist regimes were not based on the destruction of private property; this is why the abolition of repressive regimes, the cutting of military spending, the opening-up of markets solved the transition problem very quickly. The specific feature of the socialist model, its essence, was that this most complex market and private property organisation of economic relations which could not be reproduced artificially — at least relatively quickly — was crushed and destroyed. In this respect, our task was very different, and it would have been naive to expect quick solutions.

Let me now turn to the present position. This is the second IRIS conference, the first was in spring last year, and already then I argued that the links between money supply, inflation, the exchange rate and manufacturing production apply to post-socialist economies, including the Russian one. The only novelty, is the increase of the time lag between changes in the rate of money supply growth and the rate of inflation.

Towards the end of 1994, an important change took place in the consciousness of the Russian elite. That knowledge which the student usually gets from text books our government finally gained from the experience of trials and mistakes for which it paid dearly. And having gained that knowledge, they began to adjust their policy to this experience. By November 1994 it was clear to Chernomyrdin's Government that there were only two real alternatives: either to continue the policy of indecisiveness with no possibility of economic growth and wait until it was dismissed, or to commit itself to a decisive anti-inflationary policy, which was certainly difficult, but at least gave some chance for economic and political success. The Government correctly chose the second approach, but the problem with this programme was the incomplete realisation of price reform, which significantly reduced the efficiency of the tax system.

The new [stabilisation] programme does not lack common sense and realism. But almost immediately it found itself under severe threat of defeat after its launching in December 1994-January 1995. This was because it did not presuppose the Chechen campaign. I don't mean the problem of financing the Chechen war, but the unfavourable influence of this event on inflationary expectations. When our institute [The Institute of the Economy in Transition — Ed.] made a survey of inflationary expectations

by interviewing entrepreneurs, the results showed in December 1994 a sharp rise in inflationary expectations, which is natural after the beginning of a military campaign. In January inflationary expectations still remained very high. The war inevitably changed the situation on the currency market. December is a traditional time for the growth of foreign exchange, but as a result of the Chechen war the amount of foreign exchange supplied was much less. In January 1995 — against a background of military campaigns and unpleasant events — there was a sharp rise in the demand for foreign currency. This reduced the currency reserves to very low levels. Hence the forced decision by the Central Bank to increase interest rates and the ensuing decision by the Government to increase the return on government bonds. The budgetary programme presupposed international credits to the government from January onwards. Naturally, the negotiations were delayed by the war.

The first months of 1995 saw a rise in expenditure on the Chechen war, a rise in interest rates, an increase in the internal PSBR, a decrease in the possibility of mobilising domestic resources and the absence of external financing. It appeared that the government programme would be almost entirely undermined, forcing the government to revert immediately, and on a large scale, to monetary emissions in order to finance internal expenditure — an action which would have practically ended the chance of an external credit and financial stabilisation.

The government found itself with the choice between allowing the situation to drift and cutting its expenditure. It chose the latter, and this enabled it in a short period, though at a very high social cost, to stabilise the situation.

In January 1995 there was a contraction in the real rouble money supply; in February/March there began its gradual stabilisation, following the recovery of the Central Bank reserves. The money supply between 1 January and the 1 April rose by 3 per cent, or a growth of a mere 1 per cent a month. In February/March especially it became the conscious policy of the Central Bank and the Government to lower the real exchange rate of the rouble to the dollar, so that in the period of stabilisation they would not need to face an appreciated exchange rate of the rouble.

If we look at the growth of the money supply from the end of 1994 until approximately the middle to end of March, it looks as if the market did not understand what was happening. Until the end of 1994 the markets expected 9,000 roubles for the dollar at the end of 1995. Only from the end of March onwards did the market begin to sense the improvement in

monetary conditions. This led to an increased demand for roubles, and an appreciation in the real exchange rate. There are therefore quite high chances that we shall enter the second half-year with a stable exchange rate, and consequently with significantly lower interest rates and with relatively low predictable rates of inflation.

Thus there develops an interesting situation, the experience of which only now begins to emerge in post-communist countries. It concerns the relationship between money factors, factors of demand and structural factors at relatively low rates of inflation by the standards of a post-socialist economy. The experience of our neighbours undoubtedly proves that with an inflation rate of 100 per cent annually, money factors are dominating. My hypothesis, backed by the experience of other post-socialist economies, is that at an inflation rate lower than 50 per cent a year, structural factors begin to play a crucial role. Hence the relationship between money, prices, and production becomes much less clear-cut. Exactly because of that I cannot dare to predict the relationship between money supply growth and prices in the second half of this year.

Jeffrey Sachs

We live in a world of experience, not theory. Over the last five years we have had a great deal of experience of what works and what does not. Experience has given the answer to many theoretical problems posed at the start of the transition process.

In the case of Russia, two basic reforms are essential for recovery. The first is currency stabilization, the need for which is demonstrated by the continuing extraordinarily high rates of inflation. The second is the establishment of competition in the market place through international trade. The EBRD Trade Report shows a high correlation between levels of trade reform and economic recovery. The evidence shows that with only moderate reform output falls, but with no reform at all output simply collapses. Russia must therefore revive her trading links in order to maintain her levels of output.

One of the main debates of the last five years in Russia has been about whether high inflation rates have monetary or non-monetary causes. This debate has greatly influenced the character of government policy towards fighting inflation. What I would like to say is this. As long as one goes on believing that inflation has non-monetary causes, one will never get inflation down. Experience proves that structural reform alone does not produce currency stabilisation.

Another point of recent discussion, is the choice between open trade and protectionism. The benefits of protecting certain industries in the transition appear attractive. But again, international experience shows that this is delusive. There are no examples of countries with closed trade and successful economies, while no country with open trade policies has stagnated.

Another dilemma facing policy makers has been whether to improve industrial efficiency through competition in the open market, or to give subsidies to inefficient industries to 'get them back on their feet'. Again, it is clear that the latter course is a guaranteed path to failure.

Finally, people have debated the choice between the centralization and decentralization of power within Russia. In a country as large as Russia, decentralization makes sense because the decentralization of power across the regions would promote competition in the successful implementation of reforms, thus creating a dynamic movement towards greater economic efficiency.

Sergei Glaziev

Mancur Olson's analysis showed that the transition to a market economy carried the character of shock-changes in practically all spheres of our previous society's organisation. The systems of resource distribution and economic calculation were destroyed, the system of controlling economic behaviour was abolished, the old system of law and order was crushed. It was reckoned that market mechanisms could be developed and used immediately, filling the vacuum created by the collapse of the previous regime. But in order for market self-regulation to lead to economic efficiency and economic growth within a few years certain preconditions must be developed. The system has to be competitive. Market discipline should be working. And there should be macroeconomic equilibrium between supply and demand, able to be maintained relatively easily by control of the money supply.

But obviously, these pre-determinants do not create themselves. The relevant legal institutions should be working, the relevant civil laws protecting the rights of households to property should be working, as well as the enforcement of contract, and settlement of disputes. Moreover, there should be in place a relevant ideological system which aligns motives of entrepreneurial behaviour to the recognised system of norms and standards. Managers and entrepreneurs should want to maximise the prosperity of the property they own; decision-making should be geared towards increasing efficiency of production. And, of course, the majority of households should be able to compete in the market. For this supply and demand need to be structurally aligned. If these preconditions are absent, macroeconomic stabilisation can be achieved only by degrading the economic structure. The alternative is prolonged inflation which allows the non-competitive parts of the economy to survive.

None of these prerequisites were present during the first stage of reforms. And the spontaneous activities which developed as a result of the liberalisation of the economy produced their own specific pathologies, their own distributional conflicts, and their own type of entrepreneurial behaviour.

One key element of the pseudo-market which developed in the Russian economy was chronic enterprise debt. Another was systematic racketeering and non-judicial settlement of disputes as entrepreneurs were forced to create their own security bodies and resort to criminal methods because of the absence of an enforceable system of commercial law. This system of

self-organisation was based on theft of state and private property as well as corruption in the administrative distribution of resources.

In such an economic climate, competitive advantages are determined by the entrepreneurs' links with the administration and by their links with organised crime. Households do not own real productive assets, which require serious expenditure on their maintenance, long-term planning and a stable macroeconomic situation. A very peculiar capitalism developed in Russia, which no longer exists in developed countries. It can be characterised as a criminal-speculative type of capitalism, the basis of which was created by financial and trading intermediaries with help of close links to the state distribution of monetary and property resources. These commercial intermediaries practically monopolised the distribution of money and property.

Parallel to this, there was capital laundering and money laundering from the production sector. There was a net transfer from the vulnerable manufacturing sector and households to the financial-speculative sector. This happened through elementary market mechanisms: in such a chaotic pseudo-market economy, the profitability of productive operations turned out to be much less than the profitability of financial-speculative operations.

These mechanisms in the economy were complemented by politics. Pressure groups developed which began to reflect the corporate interests of entrepreneurs who were able to gain comparative advantages in this chaotic climate. Stable political groups were formed to promote the interests of the financial-trading sector and the energy sector (which retained its high efficiency thanks to exporting opportunities). Among politically organised productive interests today only the agrarian sector retains its power.

The most characteristic result of this system was the speedy decline of production. Figures speak for themselves, and these figures are unprecedented in modern economic history. They state that the production of goods during the last three years halved in volume, industrial production went down three times, and the high technology sectors shrank to one quarter of what they had been. There were no reverse movements. The volume of capital investment in the Russian economy is nowadays 4-5 times lower than it was in 1991. This shows that the former scale of production cannot be restored with the economic mechanisms just described. It would be irrational to hope that in these conditions economic growth would take place on the basis of incentives for private investment.

No single entrepreneur is going to invest in sectors when the real efficiency of production is negative.

What are the prospects? It is obvious that in the technologically advanced sectors there are no prospects for economic growth. Competition exists only from the outside and is created by the large-scale imports of goods. The potential of competitiveness which still remains in the manufacturing sector cannot be realised in the present macroeconomic situation due to the unattractiveness of private investment. The speculative boom which grew up on the back of property redistribution and commodity and currency speculation will obviously fade. There has been a sharp fall in the profitability of agriculture and of imports. Thus practically all spheres of entrepreneurial activity have become unattractive to private investors.

Good prospects remain only for a very limited set of production branches which serve the export sector. These are a part of the energy sector and several energy-saving low technology production plants in the secondary sector. For the greater part of manufacturing production there are no chances of survival. At the same time, this means that economic growth is not possible because modern economic growth is not caused by the extraction of resources or speculation. It is primarily based on the production and distribution of new knowledge. In conditions of scientific degradation this potentially most important source of growth of the Russian economy is disappearing.

The fall in production means that a fall in the standard of living is inevitable. We also predict a very high rate of growth of unemployment in the near future — the increase in 1995 will probably be to 5 million — and a decrease in real earnings of people active in production, and later in intermediate operations.

So the result of this stormy adaptation of our economy to large-scale liberalisation has been the degradation of the economy and the society. A small number of very well organised groups nowadays exploit rather limited and narrowing sources of high profits. These people still retain the possibility of ruling the country mainly in their own interests by commandeering monopolistic rents — natural rent which exists in the Russian economy, and the political rent which develops from their monopolistic control over the distribution of property and state finances.

The question arises, what can stop these tendencies? The alternative is not theoretical but concrete. The key elements are, above all, the formation of institutions of market competition and self-organisation on the micro-level,

increased investment, and modernising production on the basis of new technologies.

The quality of government rule plays a tremendous role in the success of this approach. The government in Russia, like in other countries with a market economy, must be responsible for scientific research, the preservation of educational potential and human capital, long-term investment, the control of monopolies, the stimulation of industrial exports, the modernisation of depressed branches and regions, and of course improving genuine entrepreneurial expectations by ending the amazingly distortionary system of taxation. The government must do this, because governments in all developed countries do this, and the better is the condition of a country, the more efficient the government is at adapting economic potential to a changing environment.

I shall briefly state what we propose for 1995. We proposed to raise the level of investment by offering state guarantees to attract private investment and by enlarging state investment programmes. In order to achieve this we propose to mobilise profits by extracting part of the natural rent which nowadays goes to a small number of privileged economic structures and by taxing trade.

We also propose measures to raise the competitiveness of Russian industry by using the appropriate exchange rate policy, which should provide for the devaluation of the national currency parallel to the rate of inflation and by developing a government programme for stimulating the industrial market and creating appropriate export institutions, such as an Export-Import Bank. We also propose a limited amount of protection of the domestic market, including the protection of sectors which are currently non-competitive because of the massive influx of similar, but low quality products which escape customs duties and standard and quality controls.

In future we propose a tax reform to create real taxation on incomes, and measures to form financial-industrial groups which could aid the integration of financial and industrial capital. This set of reforms should provide the escape from our current problems. If adopted it would stabilise inflation at 5.5 per cent a month now, and reduce it to 20 per cent a year by the end of 1995.

PANEL COMMENTS

Grigori Yavlinsky

Russia's economy was not damaged by central planning like that of Poland, the Czech Republic, Slovakia, East Germany, Hungary, Romania and Bulgaria. Our economy was created by central planning. It has entirely different basic principles.

The methods of macroeconomic regulation adopted since communism collapsed cannot be successful in the absence of bankruptcies, of a large private sector and of market competition. But there are no bankruptcies because our government refuses to sanction bankruptcies. There is no genuine private property because the government does not have the political will to create it; this is why the voucher system was employed. Now we face the task of creating a truly private sector and having to determine which enterprises belong to the state and which to the private sector. We don't have competition because there is no political interest in competition, since the state, resting its power on monopolism, is becoming increasingly corporate and oligarchic.

Drawing on the experience of the results of monetary policy in 1992-94, it is possible to predict what will happen in 1995. Tighter financial policy will provide for a reduction of the inflation rate to 6 per per month by May. But subsequently there will be an accelerated fall in production and a new cycle of enterprise debts, leading to [new monetary emissions] and double-digit monthly inflation, possibly accompanied by events like October 11 1994 [the rouble crash — Ed.]. But everything will depend on the tactics employed in August and September. October 11 should have been an important lesson, but obviously it was not, so the intended policy will again make us choose between extremes [of deflation and inflation]. The only escape from this cycle is private property, bankruptcies and competition.

I'd like to comment briefly on Professor Sachs. I cannot elaborate on my disagreement with the comparisons Professor Sachs made with other countries, but the main thing is that Poland had a sizable agricultural private sector and therefore did react to macroeconomic regulation. The Ukraine cannot serve as an example at all because it lacked an independent monetary system.

Why won't we be able to halt inflation using the recipe outlined by Jeffrey Sachs? Because budgetary and monetary policy [in Russia] hits a monopolised economy marked by the absence of competition, private owners and markets for goods. We lost our markets abroad, then in Eastern

Europe; we lost markets in the republics of the former Soviet Union and now we continue to lose them within Russia. Without an economic union with the former republics we won't be able to deal with inflation, just as we cannot deal with it in the absence of markets in Russia, whichever monetary policy we choose to carry out. To overcome inflation, important preconditions are needed. Only then is financial stabilisation possible.

Experience has convinced me that without reforms initiated and carried out by regions, and without decentralising the tax and budget system, we cannot gain the population's trust in reforms imposed by Moscow. A government without the population's trust cannot beat inflation because inflationary expectations and inflation itself are in many ways not simply an economic, but a socio-psychological phenomenon.

Regarding Mr. Glaziev's speech, most of what he said about state economic policy is correct. But where will he find a state which, under current circumstances, will carry out what he proposed, without stealing?

Lastly, no-one mentioned the social objectives of our economic reforms, but without them reforms are meaningless.

Leonid Polishchuk

Why is economic reform in Russia accompanied by lobbying, corruption and criminality? Why is there constantly a high voltage field around it, which is periodically diffused by political and economic crises? Why, finally, does this not happen in more settled post-socialist states?

In search of answers to these questions one should note that the majority of people act rationally, pursuing their natural interests as far as opportunities allow. Their behaviour is the reaction to the surrounding economic and institutional environment, and any abnormality should be viewed as a reflection of the vices of this environment.

The market established in Russia over the last three years allowed economic agents freedom of action, and with help of prices indicates to them changes in expenditures and supplies. But the Russian market is limited by the inability of its subjects to react adequately to market signals. Such a reaction must be supported by mature markets of factors of production, especially of labour and capital. These markets enable the reallocation of productive resources in directions dictated by consumer demand.

Unfortunately in Russia, like in many other transition economies, labour and capital markets are rudimentary, restricted, and lagging behind the consumer goods market. The labour market is paralysed by unsatisfactory conditions in housing, the absence of an accessible system of services, various administrative barriers, etc. The capital market is suppressed by inadequate defence of property and contract rights, undeveloped legislative foundations, insufficient information on the economic potential of enterprises and, not least, inflation and the general economic and political instability.

As 'fonts' of economies in transition, the failures of labour and capital markets reflect on the progress of economic reform. If the economic structure at the beginning of reforms is almost entirely determined by consumer demand, then the need for reallocating resources is modest, and even immature markets of factors of production are sufficient. But if, as in Russia, central planning left a legacy of structural distortions, then the flaws in labour and capital markets have most dramatic consequences. They not only inhibit restructuring, but also produce disparities, like the disproportionate concentration of banking capital in Moscow. The absence of markets obstructs the flow of savings into investments, and the smoothing out of seasonal fluctuations. Thus for three years in succession there have been autumn crises.

As a result, Russia's economic potential is not only wasted, it is also undermined because the people who possess resources like labour, knowledge, energy, and entrepreneurial talent, are unable to use them productively, since modern technologies need the combination between these resources and additional factors of production — capital, labour, etc. However, markets which could provide such a combination are underdeveloped.

Lacking the opportunity to earn a living in a socially valuable way and multiply the nation's wealth, people are forced to resort to the redistribution of the common pie to their own advantage. The economy thus suffers a double loss — firstly, because human resources are wasted in a non-productive way, and, secondly, because those who are willing and able to produce, live in fear of expropriation of the results of their labour.

Redistributive activity, mostly involuntary, inevitably concentrates into different factions and groups. Without being sufficiently organised, it is impossible to gain the benefits of redistribution, and as a result there appear lobbies, political movements, criminal groups, financial 'pyramids' etc. Redistributive activity may evolve and change its form (for example, plans

to form a political party on the basis of 'MMM' Ltd.), thus adjusting to changing rules.

The demand for leadership of such groups is matched by plentiful supply. People with energy, readiness to risk, ability to recognise and grasp new means and opportunities, would have made classic entrepreneurs. In Russia, however, lacking the opportunity to combine their entrepreneurial talent with capital and other essential resources, they become entrepreneurs in the redistributive sense. History is full of such examples, and in this respect, Russia is no exception.

Thus, instead of encouraging a reallocation of factors of production, dictated by market demand, Russia's economy encourages redistribution of the national product outside the market at the behest of the established producer lobbies. Economic liberalism, if not supported by the necessary institutional base, is not only unable to provide large-scale restructuring of the economy, but is also unattainable. Most redistributive processes goes through state institutions, and the state thus returns as a distorted form of 'administrative market'.

Undeniably the 'twilight' of economic reform offers wide opportunities for corruption. This, in turn, produces opposition to the establishment of a fully-fledged market economy. However, one cannot overlook the fact that large-scale extra-market redistribution has serious objective reasons, unconnected to the wishes of the contestants for the common pie. The visible loss of earnings by wide groups of the population each time steps are taken to hinder redistributive activity (for example, by sharpening budgetary and financial discipline) shows that for many there are no alternatives to redistribution.

There are different ways of escaping this situation. One solution is to return to the government the function of allocating and distributing resources, and, above all, investment. This arouses scepticism not only because of standard doubts in the abilities of civil servants to replace the 'invisible hand'. More specifically, if in the fully privatised (not necessarily *de jure*, but in any case *de facto*) Russian economy the state officially starts to control the most important factors of production, enormous lobby pressure will develop which the most competent government will be unable to resist.

The opposing idea consists of banishing the state from not only allocating and distributing resources, but also from building market institutions. The state in this case is being viewed as a source of inevitable corruption and market-contrary decisions, prone to manipulation by various interest

groups. In order to fence off market institutions from distortions, private owners are supposed to lead the formation of these institutions. It is thought that this class is vitally interested in reliable protection of their property rights and the efficient allocation of privately-owned resources. Further, it is expected that this class will channel its growing economic and political strength in building market institutions in defence of their interests.

However, there is neither logical proof nor historic evidence that theory will match reality. It is unclear, for example, why those who are able to seize control over significant resources, would prefer to use their newly acquired strength to protect everybody's property rights, and not on further expansion. One more danger is that because of the perceived impossibility of creating full-blooded market institutions on the national scale, such institutions will be created on the regional level. This scenario, despite its widespread support, is exceptionally dangerous in undermining the nationwide Russian market.

Thus there are solid arguments for the Russian state to be an active participant in the reform process. However, the state must take an unprecedented role in Russian history — not as a substitution for the market, but as a consolidator of market institutions.

The road to the market is difficult. Russia's traditions, the current opposition to a market economy, and the absence of a well-defined and strong social base do not inspire optimism. But when the state is concerned to provide a public good for all its citizens, it is easier to gain public support than when the state redistributes resources. Market institutions are classic engines of social welfare, and their development in Russia with the state's active participation is by no means a lost cause.

GENERAL DISCUSSION

Glaziev

The criminal activity of state institutions is the main obstacle to economic recovery and a sensible economic policy. The reports cited during a round table discussion in the Federal Assembly on the problem of criminality, show that criminality is completely pervasive. It is difficult to talk about establishing, under these conditions, a market economy based on private property and free competition.

To answer Gregory Yavlinsky's question on where to find a state with the correct economic programme, I can state that our faction [Centre-Left Democratic Party-Ed.] decided to press for a vote of no-confidence in the present government. I propose to all who feel for our country, to back this action and form a trustworthy government that will support attainable goals.

Sachs

Glaziev talks about the degradation of the Russian economy. The only way Russia can prosper is by selling goods the world wants to buy. The steel plants have to be closed down. On the other hand, Russia has started selling semi-conductors to Hong Kong. On inflation control we have a wealth of international experience. In practically all cases inflation is caused by monetary financing of the budget deficit. Brazil is the only case where you have had high inflation with a low money-financed fiscal deficit. This is because they indexed wages, which made high inflation self-sustaining.

Glaziev

Sachs talks of sales of semi-conductors to Hong Kong. The entry on the world market with low technology products is, of course, a success. But the main source of modern economic growth remains scientific and technical knowledge. The basis for economic growth in Russia in the 1980s was its accumulated scientific and industrial potential, which was destroyed.

Gaidar

I would like to defend Professor Sachs and to warn my colleagues against political self-centredness. We now have a wide experience of life in many post-socialist countries. Instead of dismissing it, we should look more closely. There existed an agricultural private sector in Poland but not in Albania, and the results are similar. The Ukraine had no monetary system, just like Armenia and Georgia had none, but the results are different. We

should keep to scientific knowledge and not political demagoguery. Only by studying it is it possible to understand how these economies function.

It was suggested that in destroying the previous system we imagined that a market system would start working immediately. This is untrue. The socialist economic system was built on a power monopoly. The collapse of powerful structures dependent on the Party's omnipotence automatically caused the collapse of the household microstructure. Anyone analysing the processes of collapse in 1989-91 should understand this. The problems discussed here are a natural consequence of the collapse of an economy based on power: the absence of legal private property, absence of bankruptcies, absence of a normal judicial system, absence of effective market regulators, and other characteristics which developed over centuries. Since we are having an academic discussion and not a political contest, we should analyse the current situation from a purely historical viewpoint. Had we not rejected some sensible aspects of Marxism so quickly, we would understand that the present situation is the result of powerful socio-economic forces, and not mistakes made by this or that political leader.

Emil Dabagian (Institute Of Latin America)

I know Mr. Sachs as a specialist who worked on the economic reconstruction of Bolivia; I strongly respect his work and listened with great interest to his speech. But I also think one should note what Gregory Yavlinsky spoke of, namely the differences between Eastern European economies and our own. For example, in Czechoslovakia elements of the past lived on, the Soviet model was imposed; both contradict the Soviet experience. Even in the Baltic countries there was a micro-climate unlike that of other Soviet republics. These factors are very important for understanding the prospects, possibilities and rates of progress of economic and social change. More specifically, could speakers elaborate on a factor like a country's size. Does it favour or block economic reforms, bearing in mind not only Russia, but Brazil and Bolivia?

Poloshchuk

In Russia the size of the country plays a destructive role, making structural reformation and labour migration more difficult, creating depressed regions impossible to deal with.

Yavlinsky

I agree that everything should be studied, especially experiences. But comparisons are not always simple, since experiences vary everywhere: China and Poland have their own. I think the Chinese experience is unsuitable for us. We can learn from Polish experience, only not in the way it is being discussed. We can learn that first comes institutional reform, then agriculture that will react to macroeconomic tightening, and then results. This is how I see the Polish experience.

Excess monopolisation, corruption and criminality in Russia has sprung from peculiarities of our economy. Over 80 years we built an excessively monopolised system — this being the main idea and the main goal of communism. Secondly, we established an economy which could and should function without laws. Thirdly, we established an economy which could and should function without money. Then we liberalised it and allowed it a free hand. We've created a mafioso-corporate state. There was a PLC of 14 Politburo members managing a company of 130 million people. Then it was dismantled and left to its own devices. No wonder we have criminality and bribery. I don't suggest this can be changed overnight; nor even in 5 or 10 years. The problem is it is not on our agenda, it is not a component of economic policy; the problem is not so much what is being done, but what is not.

I think of reform as a bicycle with one pedal as politics and the other the economy. Mikhail Gorbachev pushed one pedal and finally fell off this bicycle. He was concerned with political reforms and did nothing for the economy. Then Boris Yeltsin began to push the economy pedal and encountered a 'White House', because he did nothing for politics until October 1993. [A reference to the impasse between the President and the Duma, ended by the Presidential 'coup' of October 1993 — Ed.] Therefore there is no choice between state-building and economic reform. We are cursed to proceed with them simultaneously.

Glaziev

Nobody suggests a miraculous economic recovery within 2 or 3 years. Because of the fall in production and the degree of structural problems it will take much longer to create a healthy economy. We must have a horizon of 10-15 years. However, on present policies, it is easy to predict how Russia will look in 10-15 years. Russia's supposed economic greatness is deceptive. Measured by the level of GDP, we're behind not only the Big Seven, but also China and India, and by the end of 1995 probably Brazil. Regarding population, in 10-15 years, according to forecasts, it will be

halved, and Russia will be a country with an average population size. This population will possibly have to sell parts of its territory; if not, somebody might simply confiscate it.

State power is inseparable from economic recovery. I will give only three relevant examples. How is it possible to normalise the economy if the government distributes financial resources corruptly? In market economies state purchases are distributed by tenders, in line with the law. The Ministry of Finance is either unfamiliar with this law or considers it unnecessary to follow it. The same with taxation and financial discipline. The imposition of tax discipline is very difficult if the main method of balancing the budget is the rejection of government obligations and non-payments of salaries. And, finally, how is market competition possible without a legal system?

Question

Will the creation of an elementary social order not require an authoritarian regime — something like Pinochet in Chile? Aren't we heading towards it because social tensions inevitably create new Mussolinis?

Glaziev

I'd like to respond to that. I am very surprised at the twists of the liberal idea, when at first the government is criticised for its inability to proceed normally, and then there is readiness to succumb to a new stationary bandit who should impose order and inculcate liberal ideology. The chance of this stationary bandit being liberal is zero.

Gaidar

The age-old issue of financial stabilisation versus institutional reform was raised. To me the question seems comical, because obviously it is better to be healthy and rich; better to have financial stabilisation and institutional reforms; better to have institutional reforms earlier than later. Without developed systems of markets and civil justice, the market will work badly, this is certain. Only it should be emphasised, and the experience of Russia and other countries shows this, that incomplete large-scale institutional reforms do not hinder effective financial stabilisation. Many post-communist countries have had undeveloped institutional reforms and stable finances.

Regarding corporate management and the possibility of the recovery of state order, one circumstance gives me optimism. The same leaders of

national business who only years ago were concerned with getting some favourable quota or privileged credit nowadays begin to think how inconvenient it is to do business in a state without a normal legal system, civil law, a legislative system and contract enforcement . Nowadays this is seen as a serious problem hindering investment by increasing investment risks. The attitudes of the Russian elite now show support for any action reviving the efficiency of government enforcement. This gives me hope for an alternative to the stationary bandit.

The main problem with corporate governance is institutional — the close relationship between ruling and property-owning. The press is very busy reporting the maltreatment of private owners. We now struggle for the establishment of property-owners' control. In many ways this will be a struggle to the blood. If it ends with the victory of property, then a truly efficient corporate management will be established; directors will cease stealing. The main tasks of a moderately responsible government are: a) to secure property rights, and, most importantly, b) to defend the interests of private property from any threats. Only then can Russia's economic growth be stable in the long-term.

Chapter Three. Speeches: Yavlinsky, Urnov, Mau

Grigori Yavlinsky

I wish to offer a short analysis of the radical Russian reforms in the years 1992-94. Since the primary task of the Russian reformers in these years was the struggle with inflation, and the most important, if not the only, instrument in this struggle was monetary policy, I propose to study the course of Russian reforms through the prism of questions posed by monetary policy. The second part of my presentation suggests conclusions for macroeconomic policy arising from this analysis. I shall attempt to show that the effect of monetary policy is limited in specifically Russian conditions.

Attempts to use monetary policy to bring down the rate of inflation below the structurally-institutionally determined level of inflation have exclusively negative side-effects — above all, a slump in production and the growth of enterprise debts. Not only do we have to pay dearly for every reduced percentage of inflation, but also the reduction itself is in many ways a phantom because inflation is not reduced but suppressed, the lack of money in the economy being compensated by the growth in debts and a decline in production. Inflation falls temporarily and inevitably springs up again, as soon as the sharpening of the problem of non-payments and industrial decline weakens political support for the strict actions of the Russian government.

My main idea is that in order to achieve an inflation rate below the current structural-institutional rate, a new economic policy is needed. It should be geared not towards the reduction of the rate of inflation at any price, but towards the reduction of the structural-institutional level of inflation. This policy should be determined for several years ahead, at least three or four, and directed towards the dismantling of the socialist foundations of our economy. It is useless to water a tree planted on a stone wall. In order for it to survive one should transfer some earth to it. In the same way, it is useless to resort to monetary instruments of economic stabilisation only; and inflation is the result of, among other things, structural-institutional problems.

Between 1992 and 1994 there were two attacks on inflation. The first was in the first half of 1992 following the liberalisation of prices in January. This was the stage of sharp monetary tightening. Money supply growth was restricted to 9-14 per cent a month, but the real money supply dropped five times. As a consequence, the monthly rate of inflation decreased from 38.3

per cent in February to 11 per cent in May. The real effect was a shattering fall in output, and the growth of enterprise arrears.

These circumstances determined the retreat which began in the summer of that year. The government did not have the strength to persist with its austerity policy in face of a supply slump which came to 18 per cent by the end of 1992. The new head of the Russian Central Bank, Victor Gerashchenko [appointed on 17 July 1992 — Ed.] reduced the debts of the Russian enterprises by increasing the rate of growth of the money supply by two to three times, and allowing the rouble to fall on the foreign exchange market. As a result of these measures, the real money supply increased twofold, the crisis of non-payments was overcome and the commercial banks accumulated monetary resources. The rate of inflation increased to 26 per cent a month in November, but industry recovered somewhat.

The second attempt to deal with inflation in the winter of 1992-3 differed from the first tactically. This time the course taken was a gradual contraction of the money supply and, consequently, a steady decline in the rate of inflation. In the course of almost the whole of first half of 1993 the policy of lowering the rate of inflation by 1 per cent a month was successful, making it 18.5 per cent in May. On the whole, this was not even accompanied by a fall in industrial production or a non-payments crisis. However, the drop in the real money supply to 20 per cent of its 1991 level in May 1993, and its consequent further decrease activated new economic shocks.

The Russian government hoped that the achievement of the planned reduction of inflation to 7 per cent in December 1993 would turn around the economic situation by encouraging private foreign investment as well as credits from the IMF. This was an understandable logic, and by acting in this direction, the government stubbornly continued to contract the money supply, lowering it in the course of the last months in 1993 to a record low of 14 per cent of the 1991 level in real terms. The monthly rate of inflation fell by almost a half [to 13 per cent — Ed.] in December 1993.

However, the consequences of excessive tightening of monetary policy began to show. The ratio of enterprise debt to enterprise funds which fell towards the middle of 1993 to 83 per cent rose to 133 per cent on October 1 and to 190 per cent in January 1994. The main characteristic was again the growth of mutual non-payments of the enterprises, and a further decline in the volume of production. The scale of industrial decline in 1993 was almost the same as in the previous year. [Industrial production fell to 80 (1991=100) by December 1992, and 68 by December 1993 — Ed.]

Restrictive monetary policy continued in the first quarter of 1994. The average monthly rate of M2 growth fell to 8.6 per cent a month, compared to 12.3 per cent in the fourth quarter and 17 per cent in the third quarter of 1993. As a result inflation fell dramatically from 17 per cent a month in January 1994 to 7.4 per cent in March. Real money supply growth was held at the exceptionally low level of 14 per cent of 1991. Enterprise debts to suppliers were three times higher than their balances at the end of the first quarter of 1994. Real industrial production fell almost by one quarter.

The deflationary shock of the first three months of 1994 appeared as an expected consequence of the governmental attempts to crush inflation at any price. Then came another softening of monetary policy. The average monthly rate of M2 growth, which was 8.6 per cent in the first quarter, rose to almost 14 per cent in the second quarter. In August the rate of growth of M2 was 12 per cent. Yet the rate of price increases continued to fall to a record low of 4.6 per cent a month in August.

This paradox can be explained simply. In spring-summer 1994 there was the peak of building financial 'pyramids' and companies. The increased money supply, initially intended for the consumer market, was absorbed into the market for speculative financial operations. The embodiment of this period were the stories about the company 'MMM' [A financial trust which invested in itself. It collapsed in 1994 — Ed.] Financial speculation unwittingly helped the government's anti-inflationary policy.

Since the reduction of the rate of inflation at this stage was achieved not as a result of the tightening of monetary policy, the real money supply in April-August was growing and towards the end reached the critical mark of 20 per cent of its 1991 level. Corporate arrears declined and output started to recover. In the last quarter of 1994 the correlation between the M2 growth and the inflation rate reasserted itself, and inflation in the fourth quarter of 1994 shot up to 15-16 per cent per month.

This experience shows that if the real money supply falls below 20 per cent of its 1991 level — that is, consistent with a 10 per cent monthly rate of inflation — output declines, and the political will to continue with the anti-inflation policy goes into reverse, 10 per cent a month is the currently sustainable rate of inflation.

To reduce the sustainable rate of inflation requires the strict regulation of monopolies and competition in services. Privatisation must reach strategic areas, and proper financial institutions must be created. A reform of regional economic foundations is needed. We need protectionism to

encourage domestic industries to compete. Most importantly, demopolisation of our economy is absolutely essential.

Marc Urnov

Yavlinsky's speech determines the tone of mine, as I believe in presenting contrasts. He spoke on a specific politico-economic theme, but I as a political scientist, shall speak in general terms. I shall discuss political dynamics in the country, like where we are and where we are going. Political scientists are often asked: From a political angle, is the country an authoritarian regime or a democracy? My answer: it is neither. We are in the classic transitional period with all its advantages and disadvantages.

What is a stable democracy? I think it is a competitive market for power where the infrastructure of the market is determined by political and social institutions.

In order for this competitive market to exist, many cultural and psychological preconditions are needed, such as the appropriate legislative foundation, a highly functionalised state machine and a socially structured society. Parties are needed, and, in the economic sphere, a competitive, demopolised, efficient economy. But it is clear that the path to a stable democracy is long and hard. What is there now? There are laws; there appeared the first democratic Constitution. However, in the spectrum of expert analyses, the super-optimists insist on 150 basic laws for the Constitution to function, the pessimists insist on 1000, and the super-pessimists on 3000. Last year the Duma passed 80 laws, of which only 20 are basic. However, there is only one truly basic law — the first part of the Civil Code. This year 60 other laws are planned. It is easy to estimate the time needed to fill the legislative holes. And it is easy to understand that as long as these holes exist crises in politics and the economy will exist.

The same can be said about constitutional procedures. The level of institutionalisation of society and state from the perspective of stable democracies is very low. This provokes periodic crises such as the Chechen.

For a stable democracy a firm balance between power branches is essential. The legislature, the executive, the judiciary and the mass media form a rectangle. The Constitution did balance the legislature and the executive, but, clearly, the optimal point is not yet found. Regarding the judiciary, the implementation of judicial reform and the creation of a normal court are still in the future, so it is difficult to elaborate on it. The mass media is a special case, for it has not yet been integrated into this balanced structure. Even the democratic mass media continue to evolve in total opposition, not in an effective dialogue, with the three branches of power, thus making the system unbalanced.

The distribution of forces between centre and regions is another aspect of the discussion on the distribution of power. Only after 1994 was it possible to say confidently that the threat of Russia's break-up had passed. Before that it existed because of the mentality of regional elites, and the confrontation of the governmental organs at the centre. At present, the process of power redistribution has come to a level of trying to work out calmly a system of mutual delegation. *A priori* an optimal point cannot be found, but even the Chechen crisis illustrates the stability of the current situation. The widespread opinion that it would lead to separatist explosions has not materialised. Neither the republican nor the regional elites were interested.

A stable democracy also needs to have developed, mature elites which can absorb new people and respond to public opinion. However, at present we only have powerful influence groups on the regional and federal levels, and in politics and business. But these groups are not elites in the classic sense. Firstly, there is no mechanism of renewal; groups are still based on command, with their fate hanging on the fortunes of their leaders. Secondly, and most importantly, the elites are not viewed by society as vanguards of positive, better values. Relationships between society and elites, society and power, and society and social institutions, are those of total mistrust; this was so in the 1970s and continues at the present, in contrast to the situation in stable democracies. But nevertheless, elites are evolving. The leaders are still liberal, I think.

If elites can be called proto-elites, then political parties in Russia can also be called proto-parties. Using Samuel Huntington's classification, parties now are not totalitarian parties, but groups in transition from clique structures, with a very high role for leadership, but which have not developed as ruling mechanisms and, with rare exceptions, do not possess a structure of regional representation. Only the Communist Party was relatively well established, but it was an integral party, to use the classification of representative and integral parties. Strong integral parties are, of course, disadvantageous for the formation of a democracy, but Russian democratic liberal parties are still weak. Society is a public structure, but structuring happens slowly; the borders between social groups are still blurred and people cannot identify themselves with a particular group. Lack of structuring is a serious reason for weakening party programmes, as they cannot be addressed to a social group because there are no social groups.

As for developing a civil society, around two thousand public organisations existed in Russia by 1994, and though their numbers are growing, it is not

enough to establish stability. It is difficult to say how long this process will take, but probably longer than 5 or 10 years.

In the sphere of public opinion most interesting developments are taking place. From 1985 to 1991-92, there was an unprecedented de-communisation of consciousness and rejection of traditional communist values. This process could not have been even, of course. There was a turning point approximately in 1992, enforced by the transition to economic reforms and the destruction of the myth of Russia's quick recovery. There were signs of an ideological regression. However, public opinion will undoubtedly begin to normalise and stabilise. I'm not apprehensive, unlike some colleagues, about sociological surveys which show that 80 per cent want a 'strong hand' and only 8 per cent support democracy. Out of this 80 per cent wanting a 'strong hand', 70 per cent insist on free elections, reject the necessity of press censorship and believe in a society based on law. In other words, people want order, not dictatorship.

There have also been significant changes in values. I have an example from my own findings. In 1992 I conducted a survey in which I asked respondents to agree or disagree with the phrase: 'Personal freedom is a more valuable and sacred concept than Motherland'. In 1992, 20 per cent agreed; in 1994, about 50 per cent. This does not mean that society rejects patriotism. It means that the value of privacy is growing and society is being de-ideologised. With respect to ideological values and political orientation, the political spread of the electorate is much more centrist than that of political parties. The poles characteristic of the electorate are closer to each other than the liberal ideology of a democratic party or the socialist ideology represented by the communists.

The Chechen crisis also showed society to be much healthier than supposed. At the time of crisis no sparks of strident nationalism were detected, despite strong attempts to ignite them. Moreover, as a result of the crisis aggressive policies are less popular. The popularity of aggression was growing until 1991. This was probably connected with a declining fear of the state. When in 1987 I made my first survey of opinion, I found that even among the Moscow elite there were people more scared of the government than of nuclear war. In small towns the situation was even worse. After 1991 people, at least in big towns, started to relax; in small towns and villages fears remained, but were on the decline. However, the popularity of aggressive leaders began to grow. Chechnya showed what coercion really is, and society turned away. As far as nationalism is

concerned, about 15 per cent of the population are taken in by nationalism, which, for a transitional period, is not much.

What awaits us in future? I think that all the preconditions are now in place to make the Duma moderately liberal after the forthcoming elections. If liberal parties behave sensibly, the Duma may become normal. This could create healthy preconditions for the presidential elections and lead the country to stability, insofar as it is possible in conditions of transition.

Vladimir Mau

I shall approach the problem of economic reform as a series of rejections of economic and political illusions, as a transition from artificial theories and a mythologised economic systems to the real problems and processes of transforming what is commonly known as a 'Soviet-type economy'. Hence I shall reinforce Jeffrey Sachs's point about the importance of ideas for a productive realisation of economic reforms.

The first question concerns the old dispute about Russia's peculiarities and the necessity of bearing these peculiarities in mind during the reform process. Russia's peculiarity is that she needs to overcome not an imposed, but her own economic-political regime, one created by Russia herself. This is a truly revolutionary process, which in its breath, character and logic can be compared with all great revolutions of the past.

Here I would emphasise only one historical aspect of the revolutionary transformation which started in 1985, namely that the history of the Soviet (Russian) reforms of the last decade is in many ways a history of illusions and the overcoming of illusions, the hostages of which were politicians, analysts as well as the main mass of the people. The stages of the development of Russian reform are the stages of the rejection of those illusions.

The most crippling initial illusion was that there existed a wide social agreement about the character and the direction of reforms. The reforms were presented as so matured and natural that sometimes reformers believed that there was nobody able and willing to resist them. Understandably, the initiators of perestroika did not expect a cloudless destiny for their offspring. However, the field of possible resistance was assumed to be confined to the narrow sphere of the party leadership and the old party establishment. As far as the population was concerned, they saw at most the danger of the 'remnants of conservative thinking' which were supposed to be overcome by rallies and slogans like 'start perestroika in yourself'.

From the postulate of the existence of a unity of views there developed the illusion, typical of the perestroika period, that reforms would be easy. There was no sense that courses of action might be contradictory — that the anti-alcohol campaign might undermine the government's budget, that there could not be a simultaneous increase of savings and consumption, that 'acceleration' might conflict with 'perestroika'.

The illusion of an all-powerful government was based on its supposed democratism, popularity, and its readiness openly to address problems. However, confidence in this popularity led politics into a trap, when the leaders revealed themselves to be incapable of taking unpopular, but critically important decisions for the country as well as for their own political survival. Not for nothing did the thesis that the Soviet economy could be reformed 'without lowering people's standard of living' reign for so many years; moreover, the influence of this postulate was so strong that even economists in opposition to 'the most popular government' of the USSR were not able to overcome it. It led to colossal hidden inflation which practically destroyed the national currency and the rouble savings of the population. It was still proclaimed in the programme of 'Five Hundred Days', whose rejection led to Yavlinsky's resignation from the Russian government in the autumn of 1991.

The illusions of the politicians were fed by those of the Soviet economists. The country's leadership under Gorbachev quickly accepted the idea of moving to a market economy, in which decisions about what to be produced were decided by households not by the state. However, such economic ideas perceived as progressive in their application to the Soviet economic system, in reality were built on the logic of this system and did not presuppose the weakening of its base. Meanwhile, the most gradual realisation of these ideas in practice led to the rejection of fundamental, system-forming elements of the Soviet order (starting from the mechanisms of centralised control of the economy and political control of the behaviour of households), which inevitably led to a change in the logic of its functioning. Here the recipes which were developed on the old plane of co-ordinates turned out to be contradictory.

Another illusion of the perestroika years was that of the existence of a Soviet state — the USSR. In reality the First Congress of the People's Deputies of the Soviet Union (May-June 1989) revealed that different Soviet republics and their leaders had completely different views on the development of the country. Some of them accepted models of Western democracy, others the experience of the countries of South-East Asia which provided high rates of economic growth on the basis of authoritarianism, others wanted to preserve neo-communism, though with much stronger nationalistic overtones.

Finally, there was and still remains, the illusion that escape from the crisis might be engineered by a single uniform plan. Even at the end of

1991, it was supposed that the then newly formed Russian government could read a plan out of a text book, when in reality the logic of its actions was dictated by the complete collapse of the old economic-political order. How relevant could 'Chicago recipes' or 'liberal fundamentalism' be when the Government daily received accounts of contracting stocks of flour and other kinds of consumer products in the country's main cities?

The start of radical economic reforms in January 1992 brought new illusions which were shed only slowly under the harsh impact of reality. Most important, was the illusion that Russia had a peculiar economic system, in which the mechanisms tried and proved effective in other countries, would not work. The classic example of this approach was the doubt of many experts that the liberalisation of prices would lead to a liquidation of the goods shortage in the course of a month. 'Nyezavisimaya Gazeta' (The Independent Newspaper) appeared on January 10 1992 with the headline 'It has been ten days since the prices were set free, but there are still no goods'. And this was no joke. Altogether, this illusion was finished with by February.

It was more difficult to shed the illusion that inflation had non-monetary causes, which still lives on among a group of economists, although nowadays it is a matter of faith, rather than of scientific argument. Our experience as well as that of other post-communist economies proves that the growth of prices always accelerates after the acceleration of the growth of money supply — with the familiar lag which changes according to the rate of development of financial markets. In my opinion, the final straw in this polemic was 'black Tuesday' of 11 October 1994 when after a prolonged monetary pumping up, the rouble acted as it was supposed to have acted, that is it collapsed.

Yavlinsky insisted on the impossibility of stabilising the macroeconomy without institutional-structural reform. However, the reverse is also correct: in conditions of high inflation (more than 3-5 per cent a month), when the only economic activities are intermediary trading and financial gambling, structural reform cannot be achieved. Firstly, there are no reliable measures of the volume of household activity. Secondly, inflation in Russia, born out of a budget deficit to support inefficient sectors, is a mechanism for redistributing resources to these sectors, thus braking structural-institutional change.

There was and still remains the illusion of the threat of the political break-up of Russia. This problem was posed in the autumn of 1991 when custom borders sprung up within the country, prompted by the understandable aim of local governments to fence off their own regional consumer markets from complete collapse. But already by the spring of 1992 the problem had disappeared. There remained its national-political aspects (Tataria, Chechnya, Tuva) which demanded special political decisions. But already no-one seriously considered the possibility of separatism. As it turned out, the problem of Russian unity carries an almost exclusively economic character. The monetary squeeze forced regional authorities to think not about keeping goods on their territory, but about how to help enterprises to sell their produce. In other words, by overcoming the goods shortage and by making money scarce, the reforms replaced the problem of subsistence with the problem of retail, making the need for a uniform market and single state obvious for practically every subject of the federation.

Finally, I cannot omit one more illusion — the attractiveness for Russia of the Chinese experience. However, an elementary analysis shows that neither economically nor politically is this experience applicable to us. The structure of the Chinese national economy is dominated by the agrarian sector and with an 80 per cent peasant population is quite different from the modern Russian one. In China 'extensive' sources of economic growth still prevail, just like in the USSR in the 1920s. Apart from that, since it was the Communist Party that was committed to capitalistic reform, there was no need for its leader to break its authority, as Gorbachev was obliged to do in the quest for real economic reforms in the Soviet Union.

So far, we have discussed some illusions of previous years, partly overcome, partly still surviving. Now we shall turn our attention to the newest illusions, the prospect of shedding which still lies ahead.

The most striking of them is the hope for a painless transition to a social market economy. However, no country, including at least two dozen post-communist ones, has yet demonstrated an alternative to macroeconomic stabilisation on the basis of a non-inflationary budget accompanied by fairly painful structural transformations. Prime Minister Chernomyrdin has at least realised this. After a two-year uncertainty with his declarations about the 'social market' and 'non-monetary methods of stabilisation', he has at last put forward a programme of action which can be defined as no other than monetary — and in

reality simply standard, the rejection of which would threaten economic and political convulsions.

I understand it when representatives of the Communist Party talk about a 'different way': they would like to return to the old Soviet system, slightly diluted by self-management of the Yugoslav type. (Let us note in parenthesis that in this way they are prepared to take the worst of both variants of socialism — Stalinist and Titoist). But it is not clear which different way Yavlinsky means; he did not suggest an alternative.

Yavlinsky talked about the excessive monopolisation of the home economy, which apparently acts as an obstacle to stabilisation. The research done by a series of Western economists (for example, by the World Bank) gives evidence that the level of industrial concentration in Russia is not exceptional. Moreover, it is not deliberate break-up or reorganisation of enterprises but consumer choice which attacks the drawbacks of monopolism and concentration. As soon as Russians were allowed to fly different airlines, Aeroflot lost the possibility of monopolistic pricing.

Another alternative is to create a strong military state — the Pinochet solution. I would like to ask: where is this strong state to come from? Even if a popular military figure were to seize power, that would not necessarily lead to a strong state. It would lead only to increased state corruption, since a poor state which relies on the state apparatus does not become strong. A poor state is always weak, and if it grants its apparatus far-reaching powers, it inevitably becomes corrupt.

There is, finally, the illusion even now quite popular with the political elite, that Russia has a choice of a model of a market economy — between the liberal American and the social Swedish. However, we have not reached this point yet. We have indeed made the choice between market and centrally administered systems — the latter is unworkable in modern Russia. Now we have the choice between an open market economy like modern democracies, and a closed economy eliminating competition, like Germany in the 1930s. Let God first allow us to live long enough to have the choice between the American and the Swedish models, both of which presuppose not only capitalism, but also political freedoms.

PANEL COMMENTS

Boris Fedorov

As between optimism and pessimism, I have always been an optimist; therefore I have no doubts that Russia will master any crisis. As far as the mafia is concerned, I must admit that when I was in government, it was not the mafia, but the President, the Government, the Prime Minister and other ministers that bothered me. I have never seen a single bandit in my life.

In 1993 when I entered the government, the biggest problem was not whether the Government had a programme — it never had one. Professor Yasin [Deputy Prime Minister? -Ed.] proposed some, possibly somebody read them, but the biggest question was what concrete measures to take for concrete problems and whether it would be possible to implement them in the particular political situation. Another problem was how to centralise revenue collection, so that government money went through the budget and not the ministries. [i.e. not through what is called 'phone-call finance' -Ed.] We succeeded in solving this problem. Then we needed to stop credits for the CIS [Commonwealth of Independent States] countries and stop import subsidies. This way we saved billions of dollars. We entered 1993 with a 1000 per cent yearly rate of inflation, and annual interest rates of 80 per cent, so we needed to structure interest rates so that people who put money in savings banks could earn a little more than inflation destroyed, in order to stop savings from disappearing, because without savings, there is no investment. Finally foreign currency shops began to accept roubles, even in the 'Pizza Hut' one could buy a pizza with roubles.

It was also difficult to abolish interest subsidies on agricultural credits, but this was done in the autumn of 1993. But unfortunately many reforms were contrary to the wishes of authorities, and it took great efforts to fight them through. But then 1994 came. I would like to know what reforms were made in 1994. [Fedorov left the government in January 1994 — Ed.] Money was spent freely; the monetisation of our economy reached high levels. Glaziev and others claim that in 1993 the rouble exchange rate was held artificially high. This is untrue; there were no artificial measures, and everything was happening because we had an economic policy.

But in 1994 this economic policy was stopped. Inflation rocked and the rouble sank. The budget fell to pieces. The expenditure incurred in 1994 was unthinkable in 1993; and 55 per cent of that expenditure was

financed by inflation. Nevertheless, some have thought these were reforms. Because when the currency crisis developed, when inflation again shot up, there was talk of a fourth stage of reforms. This is again a political statement. At the start of 1994 some people in government declared that economic romanticism was finished, that inflation would be fought with monetary methods. Remember interviews with Prime Minister Chernomyrdin; then he forgot his promises. Instead of funding expenditure from taxes, he issued treasury bonds. Science institutes in Moscow were given this paper instead of money. Is this policy? Is this reform?

Now we are in 1995. A strict budget is set up in which the projected inflation rate is already exceeded. From today there should be no inflation so that budget targets can be met. Does anyone believe they will be? Nobody does, because it is impossible. It is difficult not to agree with Yavlinsky that the budget will never be realised.

Today foreign trade privileges are being abolished. This is what Glaziev and I discussed in 1993, and I completely support him. But who created these privileges? Those lobbyists? They were created by Yeltsin and Chernomyrdin, and they themselves are abolishing them. What sort of triumph is this?

Let us talk about the liberalisation of the energy sector. Was it not considered in 1992 or 1993? Was it not promised in 1994? At last, at the start of 1995 the decision is made. Will it be made to work? Not everybody is convinced. Therefore, what is going to happen if in four succeeding years the volume of collected taxation drops in real terms; if the budget is increasingly disintegrating; if real foundations for an increase of production are lacking? Without production there are no profits, and consequently no money in the budget, no social welfare, or other politically popular notions.

But is recovery possible with high inflation? Inflation at the start of 1995 was 700 per cent annually. Now it is slightly lower. [The current annual (October) inflation rate is under 100 per cent -Ed.] Yavlinsky is undeniably right to say that the rouble will be devalued, savings will fall, the government will grab all the money from the money market, which is reserved for investment. Lots of banks hold half of their balance in foreign currency and the other half in government bonds. This is considered normal. Nobody gives credits nowadays. Clearly, the main task is rapid stabilisation; and not discussion of a one per cent monthly inflation rate by the end of 1995 or even 1996-97, but today. Will this

be done? Very unlikely. Production will increase, but where are tax reforms, or incentives for investments and savings? There is nothing of that, so in the end everything depends on political will.

Is there an image of the society to be built? We have a political system in which the executive power is independent of Parliament. Elections are initiated in order to create several groups in Parliament. Elections should lead to a change in government. Will there be elections at the end of 1995 and shall we as a result have a new prime minister? I'm not sure. Because there is nothing in our Constitution about a change of government. The only aim of this government is to stay in power a little longer. This way leads nowhere. But there are obvious alternatives. Is it unknown how to proceed with tax reform, and is it unknown what the functions of the Central Bank are? What is the use of arguing whether to pay civil servants more, when 20 per cent of the budget already goes on administration? Unless you cut down on thousands of bureaucrats, the Soviet system will continue functioning under the facade of democracy. Then in 1996 — with or without elections — we shall enter the fifth stage of stabilisation.

Despite all this, I remain an optimist. The more private banks or firms there are, the better. However, one should note that the reform process is not just ideological. Its success is measured by concrete results: the efficiency of production, labour productivity, standard of living. One can reorganise the gas industry whichever way one likes. But if as a result one person has shares worth millions of dollars [the Prime Minister, Chernomyrdin, is said to own 3 per cent of Gasprom -Ed.] and the others have vouchers worth ten dollars, then this is not yet privatisation. This is simply redistribution, not reform. Reforms consist of qualitative changes. The fact that in Russia many people were busy redistributing and not increasing efficiency, is a very big failure of reforms.

A more important problem is how to start real democracy. Today's processes cannot be called democratic. The Parliament is made up by various groups rallying for and against private property, by 'Zhirinovists' and communists, by 'Gaidarists' and 'Yavlinists', and many more. But for the majority of Russian citizens reforms are associated with high inflation, criminality, the mafia, rubbish on the streets and utter depravity. Clearly, whilst such a perception of reforms exists, results are invisible, and it is impossible to define who is really in favour of reform or democracy.

Today as we find ourselves 250 days away from parliamentary elections, and as a reactionary movement is likely to produce a majority of communists and the like in parliament, it is tempting to hide behind the facade of reforms, or rather behind Anatoly Chubais. But one should not hide behind one person; everybody must realise what is happening.

Alexei Ouliukaev

I would like to elaborate on the most debated ideas, such as the non-monetary nature of inflation. This view is partially correct; there are structural factors influencing inflation. But this is like saying that democracy is non-electoral. Of course, democracy is influenced by culture, religion, history. But it can only develop through the electoral system. The same with inflation: non-monetary factors are influential, but they develop through the movement of money. Then there is the question of the sequence of reform: stabilisation measures or property reform first? I think this question irrelevant. Clearly, monetary policy is a specific instrument to deal with a specific situation. Why monetary policy?

Firstly, monetary policy, money and its dynamics are real; they exist. But anti-monopolism policy does not exist. There are only vague ideas of what it should be, whereas monetary policy is concrete. Secondly, monetary policy can be made effective. In order to launch structural changes, there should be a certain level of investment flows, but these are not possible in a precarious financial situation. It is irrational to set a specific inflation goal. One must aim to reach a level at which investment is feasible: only then will it be possible to re-distribute investment flows, change economic structure, and provide inter-regional competition. Thirdly, monetary policy is less selective, and thus less lobbied and less corrupt. Of course, decision-making in monetary policy is not entirely free of pressure groups. But it is more so than structural policy. Structural policy produces an intolerable degree of corruption. Monetary policy is chosen not because it is especially good, but because it enables us to achieve something.

Why then were the previous attempts in 1992-94 unsuccessful, so that we again begin with the same rates of inflation as before? I think the seasonal factor in the Russian economy is important, especially the influence of political seasons. As a rule, political seasons change at the beginning of summer. Normal methods of fighting inflation are rejected, and Russian methods are accepted, such as the re-evaluation of assets, clearing, etc. Why is there such an annual cycle?

Firstly, this is linked to the economic cycle and the fact that lobby groups are in a much stronger position at this time, especially the agrarian lobby, regional lobbies, the northern region's factory sector, etc. Secondly, this is generally a more 'closed' political time when many decisions are made secretly. At the beginning there are parliamentary debates, but in the summer they quieten down, and on the basis of lobby pressure power ministries make final decisions, which are often very generous and sharply increase the growth of money supply and consequently the rate of inflation. Thirdly, and here I agree with Boris Fedorov, power ministries seem to misinterpret economic principles. They obviously become tempted to be generous, when, as a result of an increase in money supply, nothing disastrous happens. Thus monetary policy breaks, and everything happens according to Chernomyrdin's formula: that we wished well, but got the same.

But can it happen not the same, but better this time? I believe there is a 50 per cent chance, and this is supported by three arguments. Firstly, authorities do learn some lessons. Some have bound their political fate to the promise that monetary policy will last a year and not half, and this, of course, influences their actions. Secondly, the authorities, and especially power ministries, have lost a war. [Reference to Chechnya — Ed.] When they have lost a war, they lose discretion to carry out policies, and this prolongs strict financial policy. Finally, a more or less real financial structure is established, which, in response to lessening inflationary expectations, allows savings to be turned into investments.

It is strange that financial stabilisation should be a goal, whilst it is really an instrument. The goal is economic stabilisation, economic growth and social welfare. Following financial stabilisation, general economic stabilisation is determined by two things: the political will to continue reforms, and the emergence of a funds market which allows for improved financial performance to be translated into industrial investment, additional budget revenues and social policy.

Of course, the hopeful possibilities should not be overestimated. Enormous political pressure will be exercised during the parliamentary and presidential elections. A maximum degree of political will is needed here. But this time there are chances for stabilisation to succeed. Only this way can there be a forward movement in economics and politics, because an unstable, high-inflation economy is a bad basis for democracy.

Finally, I don't quite agree with my colleague and friend Mr. Mau, who said that the question of the choice between the Swedish and the American models is not relevant for today, but it will be once we get on our feet and lose some fat. I don't think a choice exists. No society, 'chooses' a model. It is only in retrospect that economists conclude that as a result of policies, a certain model got established. In twenty years time, our friends in this hall are going to talk about the Russian model. But this is going to be established not because we shall choose the Swedish or the American, the Japanese or the Paraguayan models, but because actions will be taken now which will have consequences for the situation in the future.

GENERAL DISCUSSION

Question

Yavlinsky's speech was an example of demagoguery. I would like to know how protectionism is supposed to encourage competitiveness. His programme offers the country only one alternative: growing state intervention in the economy. It seems we are again deluding ourselves into thinking that the government should determine which mountains to move.

Vladimir Yelakhovsky

Yavlinsky raised the question: which should come first, financial stabilisation or institutional change? His main objection to financial stabilisation is that monetary contraction is not working. I agree with him for the following reasons. When money was contracting, enterprises reacted by spreading non-payments, thus establishing their own mutual credit schemes. Thus monetary contraction which should have led to the liquidation of inefficient enterprises did no such thing. My point is that monetary contraction does not necessarily lead to institutional changes. How can our government go beyond monetary contraction and attend to the liquidation of inefficient enterprises?

Galina Starovoitova (Duma deputy)

I'd like to turn your attention to the subject of military conversion. Russia is not unique. But surely it is quite special because of the highly developed military sector. We were told nothing about the problems of carrying out military conversion; even the United States has problems. What do economists think about the economic aspects of spreading high technologies from the Russian military sector into countries like Iran and India, which helps to fill the holes in our budget, especially in view of the delayed aid by Western countries? Professor Sachs proposes to shut the majority of military enterprises and transfer the employees to other sectors. When I was elected to the Soviet and then to the Parliament, 72 per cent of my electors were employed in the military sector as highly qualified workers and engineers. Clearly, we cannot send them on the street without expecting a social explosion.

Glaziev

I'd like to answer your question. The threats you mentioned are real. Many such enterprises have already stopped work and some have closed down. They are not formally bankrupt, but they are producing less than 50 per

cent of what they used to; in the knowledge-based industry even less. The volume of state purchases of military technology has decreased five times. These are record rates which are the result of demilitarising the economy. The knowledge-based industry is simply bankrupt. With its bankruptcy Russia has lost her main source of economic growth — new knowledge and new technologies. Clearly, this is a due to policy and the chaos it has led to. No private investor will invest at a very high risk when there are speculative activities which allow for big profits. The profitability of continuing productive sectors of industry is negative, so the profitability of military conversion is even less. The problem of converting knowledge-based industry can only be solved by the government: by replacing state purchases of military technology by other state commissions. In the structure of aggregate demand there are areas which can be filled by the state without damaging the market economy. This was not done. The government at first attempted to improve the investment climate for military conversion by granting credits. In 1994 these incentives were stopped. Expenditure on military conversion is now very limited, and this led to the situation when the amounts spent in 1992-93 were wasted because enterprises were unable to complete their investment projects. Thus Russia's knowledge-based industry is practically destroyed. The small islands which still remain, such as the export of low technology for the toy industry of South-East Asia do not alter the general picture.

Gaidar

I'll begin with the debate about the institutional differences between Poland and Russia. The main one was that at the end of 1991 Russia was not a state. We had no more Soviet-type institutions, and there were yet no Russian institutions. In this respect, Russia was unique. She faced the collapse of communism without a Central Bank, a Ministry of Finance, customs borders and also without an army. In other words, without a single state institution. This situation was different from Poland and other East European countries, and it undoubtedly determined the difficulties to the reform process.

Regarding things which could have been done differently, it is said that in Autumn 1991 one should have dissolved the Parliament and declared new elections. This view is anti-historical. I ask you to imagine President Yeltsin dissolving by force the Russian Parliament which only in August 1991 supported him! It was impossible. Since August 1991 there was also talk of a new Constitution. Clearly, this problem could hardly be solved until the contradiction between the executive and the legislature had been revealed. Although tactically many things could have been done differently, as far as

crucial questions were concerned, in Autumn 1991 there was no real choice.

Valery Nekhaev (Tverj Region)

According to Mr. Olson state-building develops from criminality. The Russian state still retains a criminal image in its relations with entrepreneurs and households. Consequently, the population and enterprises react by becoming criminals, evading taxes and reviving the black market. My questions to our economists are: was this situation predictable, who out of the two criminals will win, and can a third party appear on our market and meanwhile use the exhaustion of the other two criminals to conquer it?

Question

Is it possible that regions can recover by themselves without waiting for programmes from the centre? Our region has its own programme of government and economic reform. Is it possible for economic recovery to be achieved by authorising state-building by particular regions?

Vladimir Stepanov

Current events in Russia are not unusual for her history — she is in a turmoil after which she will, as usual, recover but as always at the cost of the population who will gain little from it. My question is : what model of growth do you see as an alternative to such a recovery? I also disagree with Glaziev on the disappearance of Russia in 15 years. She will exist, the question only lies in the model of growth.

Marek Dombrovsky

I would like to explain why the state should not be involved in industrial policy, but should be involved in privatisation and finance. Economics gives a clear answer. There are so-called public goods which only the government can provide, such as guaranteed property rights, a stable currency, etc. In other spheres, such as production, services and investment, the state must compare its opportunities with those of the market. Especially when the government is weak and when there is criminality in conditions of transition, the government must concentrate on roles in which it is indispensable.

Another subject which should be discussed are the attempts to restore the economy with help of monetary emissions, tax exemptions, budget deficits, and production for production's sake. Many economists and politicians

cannot accept declining production. But they ignore the fact that previous production had negative added costs, that it corresponded not to public demand, but to building the military sector. This is the real reason why macroeconomic stabilisation is so unattainable: it is because there are constant attempts to either revive previous production or to keep previous production going.

Yavlinsky

Responding to the last comment, I can safely say that nothing like it was ever discussed. No-one wants to print money, establish tax exemptions, initiate inflation or revive useless production. The real problem is the following: enterprises are being shut, but capital is not re-distributed. We have a 50 per cent fall in production and one per cent unemployment. There is no bankruptcy procedure which would lead to effective restructuring — this is our problem. Another important aspect is that we have a general and not a structural fall in production. I think in many areas we should minimise production. This is not damaging if accompanied by bankruptcies, and not by simple closings, when people are still employed and get paid, because this is what happens now.

As for state involvement and public goods, there is the example of Japan, where the state is heavily involved in industry without obstructing its efficiency. Japan is also not a country with free trade. Thus our government is simply too weak, and it does not follow that this enables it to be involved in large-scale privatisation. On the question of why we cannot proceed with reforms to the end, the reason is not lack of patience. Reforms are carried out in such a way that we cannot complete them politically.

Glaziev

I would like to agree that the above accusations are false. What I meant in my speech is that it is difficult to create in Russia a social market under the present circumstances. The public goods industries have almost disappeared. And budgetary expenditures are not incurred with the purpose of printing money. I also never suggested that Russia will disappear in 15-20 years. I said that there is a dramatic tendency for the Russian population to halve. The level of GDP has already halved and continues falling. Capital investment fell to a fifth. I also mentioned the flight of academic potential which I believe is the main source of modern economic growth. In an age of technological revolutions, a slowdown in technological development means a throwback for decades.

As for regional policy: in conditions of a disproportionate concentration of financial resources in Moscow it would be too optimistic to believe that a region can develop a foolproof anti-crisis programme. I believe regions should be more active in federal politics. The current government acts independently of regions, producers and even the Parliament. The executive is in a sort of vacuum, where there is nothing but itself — no regions, no population. This is not normal for a democracy.

Dilanian (Armenian Embassy)

It is very encouraging that Russia revives her foreign economic links. But I agree with Yavlinsky that there are traditional markets, such as the Armenian, which are being lost by Russia. I think it is essential to recover traditional links with our neighbours. Nature abhors a vacuum, and I'd like to alert you to the fact that our market is actively being filled by Iranian entrepreneurs.

Victor Polterovitch

Looking at many countries that are institutionally more developed than Russia, we can see that despite simple cures, many of them are unable to beat inflation. Many Latin American countries and Israel were unable to stabilise. My question for the optimists is: what is there so special about Russian economy that gives hope for recovery? In addition, the stress on beating inflation may be correct, but nevertheless seems to me a very dangerous political slogan. Because what an authoritarian regime can do best is to beat inflation. It is difficult in an autocracy to raise the standard of living, but it takes very little to freeze prices by decree.

Gaidar

I would gladly welcome to our discussion obvious things like: there cannot be private investment with high interest rates; with high interest rates and unstable exchange rates there is capital flight; private investment needs a stable national currency. Only when these conditions are established is real economic growth possible.

Chapter Four. Speeches: Fedorov, Vasiliev

Boris Fedorov

What do we mean by reform? In my view, fighting inflation is not a reform. It is economic policy. A reform presupposes a change in the economic system, and so the problem cannot be reduced to a simple discussion of changes in the money supply or inflation.

There never has been a clear economic programme, guided by a vision of the society to be built. During the Gorbachev period many projects were discussed, some more socialist, some more capitalist, but none was accepted. There were always instantaneous alliances, when for purely political reasons slogans of reform and democracy were used in a struggle for power. It is wrong to maintain that the 'Five Hundred Days' programme was bad. Nobody attempted to implement it, even though it was developed when the chance to achieve results without a fall in the standard of living was high. We are such a rich country that we had no need to become poor. Simply to take our resources multiplied by world prices and divided by the population shows we are not poor. Salaries could also have been much higher. When discussing choices, one fails to see that there never was a choice. Reforms were carried out despite opinions in government, and despite the ignorance of some members of their technical principles. I worked in two Russian governments, and I can confidently say that neither the President nor the Prime Minister ever really understood what reforms they were carrying out.

The rhetoric of reform was always ahead of the views of the leaders. When asked what reforms were being carried out, nobody goes further than privatisation. There is a dramatic loss of confidence in the government, whilst in 1989 confidence in politicians and authorities was in certain periods overwhelming. But that chance was missed. No wonder confidence is waning, as for the fourth year round we strive for financial stabilisation. The government has no-one to blame but itself.

There is also the process of political evolution. Those who struggled with the Communist Party in 1990 were not necessarily democrats, just as dissidents during the Soviet period were not necessarily democrats. There are many examples of famous dissidents with not quite democratic credentials. Struggling with a system and rallying against repression are different from preaching truly democratic values. If there is even a question of whether or not to carry out elections, then clearly this is not democracy.

Having recently visited twenty regions, I am not convinced that separatism is overcome. The position of regional leaders seems to me thus: 'You can go on discussing anything you like back there in Moscow, but as soon as we are politically and economically more stable, we shall have it our own way'. Indeed, there are many provinces that feel quite autonomous and disregard events in the centre. Separatist feelings are not destroyed, and differentiation is great. There are regions where the minimum wage is four times higher than in others, but not because they work better, but because they resist taxation. There are regions which still restrict outflow of production from their territory. At least 30 per cent of prices are controlled regionally. This economic separatism is flourishing under the pretence of radical reforms.

Therefore one must understand that today the crucial question for the immediate future is the responsibilities that the government is prepared to take, and of its understanding of the current processes.

Sergei Vasiliyev

Owing to technical difficulties no transcription was available. The following is a translation of an excerpt from Sevodniya, 22 April 1995

Backing up the criminal theme, Vasiliev confirmed the topic of discussion was the seizure of a range of state institutions by Mafioso structures. '... But even so, while the country has been run for many years by 'stationary bandits,' it is worth marvelling that after their disappearance, many 'non-stationary bandits' had appeared ...

... The transitory nature of the state system is manifested in the fact that we have no structures to reflect the interests of social groupings. Lobbyists have taken their place, a continuing feature of the totalitarian epoch ...

... It should be noted in relation to lobbyism that initial fears have not been realised. The industrial lobby's share of subsidies is fairly low. The VPK lobby is exceptionally weak; its share of the total subsidy is insignificant ...

... The coal industry is a unique case, with militant trade unions. However even here subsidies are lower than would be expected. The unions compete amongst themselves ...

... Even in the agricultural sector the agrarian lobby is renewing itself, re-orienting itself to different interests. Currently they receive no central credits of any kind ...

... Numerous lobby groups compete against each other, leading to a situation where no-one receives more than 'agreed' ...

... Mafiosi and lobby structures are different in that lobbyists have a political objective — to obtain collective profit. With the Mafia the objectives are financial — to obtain individual profit. in the process of development their interests intertwine ...

... There is one good thing to come out of the wild excesses of corruption — deregulation. However the ability to deregulate in a transitional period is limited — the state needs to retain a mixed economy in order to reduce social injustice and tension ...

... Change is thereby a dynamic process: liberals abolish certain privileges and favouritism, the lobbyists introduce others ...

In his discussion, commenting on the lack of a legal framework in Russia today and that it is organised bandits which are maintaining order, Mr.

Vasiliyev attested this was the path to 'common law.' All that is needed is to codify it and everything would be in order. This thesis is at first glance wildly liberal, even if not completely evident. The law of thieves is the common law of the professional criminals and not the Russian population. If this were one and the same, the demand for order and protest against arbitrary criminal rule would not be the main trump card of the opposition.

PANEL COMMENTS

Gaidar

Corruption in relatively young market economies is sometimes thought an extraordinary thing exclusive to Russia, which prevents economic growth. But many growing market economies have corruption. I discussed the problems of Japanese economic growth with Japanese leaders, who told me that we underestimate the role of corruption and the shadow economy in the Japanese economic miracle. The problems at that time did not differ much from those we face now. I view corruption as a horrible evil for Russia. But we must understand that corruption by itself does not hinder economic growth. This is an unpleasant conclusion. I would not want to put it to electors. Nevertheless society needs to know this.

Corruption is closely connected to administrative rent and artificial state regulation. When people propose to introduce state regulation, they know who would benefit most. I remember when in 1993 Boris Fedorov and I disallowed export quotas on wood. There were then grave problems with selling wood at home. The lack of demand led to enormous financial difficulties for the forest industry and a decline in production. One could no longer justify export quotas, so I disallowed them. I asked my colleagues from the ministries, who insisted on quotas, to explain why we needed them with a surplus of wood on the domestic market. No answers were given. But before I had left the government, these quotas were restored. There are many similar examples. They all confirm a banal truth: the main source of corruption is the inefficiency of market mechanisms, which creates the possibility of high profits and the extraction of administrative rent. High inflation, subsidised interest rates and distribution of credits are sources of corruption, and so are protectionism, tax exemptions and tariff concessions. The money allocated for state purchases of consumer goods is the greatest source of corruption. I am sure that the agrarian lobby does not defend the interests of the agrarian sector. That is merely its excuse for extracting subsidies. The real purpose is to transfer the money abroad. They are not in a hurry to invest it into agriculture.

One must deal with the obvious. Experience shows what we already knew in theory — that in an unstable market economy too much state regulation leads to corruption; that corruption is proportionate to the number of civil servants and their discretionary power over spending. But experience also showed how to beat corruption. Gradual deregulation of the economy will enable us to reduce the size, at this moment phenomenal, of the state apparatus, because it continues to perform unnecessary functions, whilst

failing to perform those which the present situation demands. We still have many sectional ministries, but natural monopolies are administered badly because these ministries manage the energy industry in the same way as they used to manage car manufacturing. With deregulation the problem of corruption could be solved: have less civil servants, pay them better and hope they will be less corrupt.

Sergei Glaziev

The belief in miraculous cures is inextinguishable in Russia. The communists believed in the miracle of nationalising industry, collectivising agriculture and totalitarian planning, but the miracle did not happen. Similar things are believed now. Many think that if economic policy is reduced to privatisation, liberalisation and the reduction of the budget deficit, everything will regulate itself for the best. But reality is much more complex than myths. Additionally, the outcome of the first Bolshevik five-year-plan amazingly resembles the outcome of the first five years of neo-Bolshevism. We experience now the same decline in production and capital investment and the same degradation of industrial and human potential.

I also call myself an optimist, despite my forecasts being considered pessimistic and gloomy. Regrettably, experience shows them to be true. Our proposed programme which is directed towards maintaining investment activity, protecting the home market and supporting competitive enterprises, offers the only realistic basis for stabilising the macroeconomy in 1995 and stimulating growth. It does not promise to reduce inflation. We calculated that it will hold inflation within 5.5 a month. In the autumn the government announced its target of a 2 per cent monthly rate of inflation. We now have a corrected forecast of 4-5 per cent a month, only the decline in production will not be halted, as we wanted, but will be 10-15 per cent, together with the threat of an upsurge of inflation later in 1995.

Realistically, macroeconomic stabilisation is impossible when the profitability of the entire real sector steadily falls, already being negative in many branches, and when labour productivity has fallen to 40 per cent of its previous level. Hence the fall in competitiveness and the retreat of our producers not only from the foreign but also from domestic markets. Stabilisation is hardly possible against the background of massive capital flight, and an increase of unemployment to 5 million. It is also difficult to expect stabilisation when instead of competition there is endless rivalry for the exploitation of rent. Clearly, this stabilisation comes only on the basis

of degrading commercial structures and transforming Russia into into a 'gas-oil republic' where a market equilibrium on the basis of world prices will be provided; the rouble will be stabilised, but manufacturing industry will drastically contract and unemployment will have to be funded by endless financial loans.

The present situation is made more unpleasant by the debate about the government meeting budget targets. I wish to correct Fedorov who said that budget targets will not be met as inflation has risen. True, inflation is one and a half times higher than in the budget projection, but it is not difficult to meet targets when high inflation is already taken into account. This budget target will be met, and there is no heroism in this.

It is said that Russian enterprises are adapting to the transition to a market or quasi-market economy amazingly quickly. But in reality they adapt by accepting semi-legal forms of entrepreneurial behaviour, like evasion of taxes, non-payments, diversion of resources from large-scale enterprises to small-scale private firms. The one element of this adaptation, which has already been exhausted, was plentiful capital.

I believe there is nothing more dangerous than complacency in the present situation. In particular, we should be alarmed by the disappearance of those locomotives of growth concentrated in the scientific-industrial sector. Macroeconomic stabilisation is inconceivable with progressive loss of competitiveness by most Russian enterprises, and in conditions of high corruption. I categorically disagree with Gaidar when he said that corruption is not a significant obstacle to economic growth. With corruption there is no competition; and with no competition, there cannot be economic growth. Therefore fighting corruption is essential for economic growth. Stabilisation is also impossible in conditions of ethnic wars, but the threat of ethnic wars exists. To think that national conflicts and criminality will be disappear by themselves is sinful complacency.

For an optimistic scenario a concentration of political will is essential. I see no difficulties in the struggle with corruption. Well-developed methods exist for distributing government-owned resources through competitive tendering. We know most pathways which are used by enterprises for tax-evasion, and there should be no problem in shutting them down and blocking the appearance of new ones. We also need the political will to help enterprises to enter foreign markets, backed by a strong Russian government. Also, it is possible to solve ethnic problems, such as in Chechnya. It is understandable that a criminal regime is bad, that the government should use its power to liquidate it, but in this case the most

primitive method is chosen, and civilians suffer most. The same primitive instrument is being used in economic policy. True, a budget deficit is bad and inflation should be fought, but obviously not at the cost of the colossal contraction of real expenditure and the real income of most of the population, which has already started to die out, as demographic statistics show. Therefore, it is not enough to be an optimist. In order to realise the benefits of a market economy, it is necessary to make this economy socially orientated and directed to the welfare of the majority of citizens.

GENERAL DISCUSSION

Semionov (Institute of Latin America)

The reason for the tragic demographic situation which the pessimists talked about is the ecological catastrophe. When predicting Russia's integration into Europe, the problem of ecology and the cost of investment in the restoration of the environment requires serious attention. What is the attitude of the speakers on this problem?

Glaziev

I would like to respond this. Environmental policies fit very badly into stabilisation policies because of the huge expenditures needed, though these policies do stimulate demand in high-technology industries. The Democratic Party which I represent, proposes federal programmes for restoring the environment, stimulating demand in the high technology industries by increasing private costs of ecologically damaging enterprises. But this seems to be difficult to reconcile with the current conception of stabilisation.

Vasiliev

In the course of the conference the discussion has digressed to everyday political questions. But I would like to emphasise that the current Russian government is the first constitutional government we have ever had; this is the first time we have been a nation state since the 17th century. But it is naive to believe in a quick transition to a civilised state. To work in government is extremely difficult — many former members present today would agree. Sometimes one is forced to deal with unpleasant people in order to prevent mishaps. So please take pity on the Russian government and the Prime Minister. Looking back three years and thinking of what might have been, I think that, compared to expectations, it hasn't turned out so badly.

Andrei Illarionov (Institute of Economic Analysis)

I'd like to refer to Glaziev's aim to have a 5.5 per cent monthly inflation rate which should provide for economic growth. Now, an average monthly inflation rate of 5.5 per cent means 90 per cent annually. An analysis of over 120 countries from 1960 to 1994 showed that there has been no country with stable rates of economic growth and an annual inflation rate of 90 per cent. Economic growth starts only when

inflation rates fall below 40 per cent annually: the lower the rates of inflation the higher the rates of economic growth.

Vasiliev has mentioned the need to raise salaries of civil servants. In 1994 the real expenditure on the maintenance of the state apparatus rose by 70 per cent, while real GDP over the same period fell by 20 per cent. This is unique not only in Russian history, but in world economic history.

Vasiliev

May I comment on that? I was emphasising the fact that the growth in expenditure on state institutions was not reflected in salaries. I would be too embarrassed to tell you how much civil servants are paid nowadays. The real problem is that salaries in the commercial and government sectors move in opposite directions.

Glaziev

Lowering inflation to one per cent a month is too high a price to pay for the liquidation of much of the industry of the country.

Kydrov (Institute of Europe)

I would like to come back to the debate between optimists and pessimists. The prediction that Russia's population will soon fall by half is horrendous. It ignores some important factors. First, we have reached such a low that there is nowhere deeper to fall. Secondly, inflation is falling and the growth of output is about to start, despite statistics which underestimate the growth and overestimate the fall in output, which is typical of transitional statistics. Are savings of which 26-28 per cent are out of personal nominal incomes, and foreign investment which increased over last year, not positive factors? Then there's the cycle: clearly, growth must follow crisis. There are laws independent of government and policies, and one should count on them. I'm convinced that growth will get going in 1996, the year of elections, as it happened in 1980-81 in America with Reagan. If we grow by 5 per cent a year in the next 10-15 years, what will happen? If at present Russian GDP amounts to 12-13 per cent of American and 36-37 per cent of the German, then in 2010 it will amount to half of the German GDP. Then there will be a different problem — Russia's place in Europe.

Dabagian (Institute of Latin America)

I would like to continue in the same vein as my colleague. Mr. Glaziev said that he is an optimist but also a pessimist. Pessimism and optimism are not just personality traits, but are based on knowledge of certain law-like tendencies, in this case of the economy in transition. When economists abstract themselves from politics, their positions converge. It is when they talk as politicians that a rift develops. I think Fedorov was pretending when he said he has never seen a bandit; there are bandits in the State Duma. Corruption exists in capitalist as well as post-communist countries. But it does not destroy economies. Four years ago the Institute of Latin America had a seminar on Bolivia. One of the coordinators asked whether the drug business contributed to Bolivia's economic growth. The Bolivian ambassador refused to comment, but everybody knows that it does. My message to economists is that if economic recovery in conditions of corruption needs time, reforms must be executed in stages.

Glaziev

It has been said that output is being underestimated. But GOSKOMSTAT [State Statistical Agency] makes an estimate of the informal economy which takes this underestimation into account. The only thing to argue about is whether the correction is enough. In reality there is not much possibility for underestimation. And I don't think that GOSKOMSTAT can really be accused of deliberately underestimating production.

I would like to challenge Professor Kydrov's assertion that we have fallen so low that we can only go up. Statistics show that the decline in output still continues. It is slower than last year, but still significant. The government's prediction for 1995 is that the decline in production will be just over 5 per cent. Our prediction is that it will be 16 per cent. We have already reached bottom in many manufacturing industries. This prediction is not pessimistic, it is realistic. We predicted a fall in output of 20 per cent in 1994. Nobody believed us. We were told we were catastrophists and trying to intimidate the government. But we turned out to be right — the decline in production was 21 per cent that year, in car production around 40 per cent. These were record rates.

The same is true of demographic predictions. In the last decade the number of children born was 25 million less than on previous demographic trends. Will there be a compensatory increase in the birth

rate, like after the war? Unfortunately, widening social inequality and declining real incomes don't inspire optimism.

What about future economic growth? Here one should be an economist, not a politician. If the level of capital investment falls by a further 18 per cent, as predicted for 1995, how is growth possible in 1996-97?

Fedorov

If there are bandits in the State Duma, one should submit a list to the Chief Prosecutor. I think that corruption is unacceptable. But corruption is not fought at any governmental level. They say there is no bribe-taking in our country, that the real problem is inflation in the budget, the immense inefficiency, the 'black holes' where money and resources disappear. But 60 per cent of credits do not reach their intended destination. Thus the source of corruption is the state apparatus.

I agree that statistics do not reflect everything, for example, statistics are not adjusted for the the growth of the service sector. But to say that everything is in fine order now is also wrong. Let's look at our savings compared to other countries: where are the pensions funds? Where are the insurance funds? Where are the investment funds. The savings, which are deposited mostly in dollars now, don't go towards production. People fly to Abu-Dabi on charter flights to stock up goods. Therefore this base for investment does not exist.

Regarding foreign capital, there should be no illusions, because the market collapsed. Today it has slightly recovered but until August 1996 there cannot be an inflow of foreign capital. Investors are not idiots. There are some who will invest something, but this is not big money and partly it is even repatriated Russian money.

The problem of the birth rate really exists. Life expectancy is also falling. But a quick note of optimism: Boris Nemtsov was on TV and said that women in the Nijni Novgorod area are starting to have more children. So in some regions, mayors are trying.

Perhaps we have reached bottom in the fall in output. But possibly we shall stay at the bottom for a long time, because [the social policy] we now have encourages directors not to cut workforces. Optimism springs from the fact that as problems become more obvious, directors will act themselves. But until there is a strong lead from the centre, policy will not be geared towards solving the problem of criminality and

corruption. No wonder many people want a 'strong hand' because a strong hand is better than a shivering one.

Gaidar

Nobody disagrees that corruption is the most important infection and that the fight against it is the most important one facing the state. I only warn you against thinking that it will be easy. My colleagues who spoke so determinedly of the necessity to fight corruption, headed two organisations: the Ministry of Foreign Economic Relations [Glaziev — Ed.] and the Ministry of Finance [Fedorov — Ed.]. The Ministry of Foreign Economic Relations, unfortunately, is reputed to be a corrupt organisation. The Ministry of Finance's reputation is slightly better, but not impeccable. It seems that my colleagues did not succeed in dealing with this problem during the time they were in charge. If we want to fight corruption seriously, we mustn't promise to beat it as soon as we elect the right leader, but recognise the key problems which cause corruption and address them.

Glaziev

I want to tell you a story which shows that fighting corruption is not extraordinarily difficult. My experience at the Ministry of Foreign Economic Relations shows that it only needs the will and support at the top. I was forced to sack about a third of my staff for distributing privileges in foreign trade. There were no problems with this. Others were suspected. To deal with these we relied on parliamentary control. The deputies like to control ministries. And I invited those deputies who wanted to control the Ministry of Foreign Economic Relations, to deal with the suspected corruption. This activity was very useful because it enabled us to keep people under pressure. The third measure was the transition to a market distribution of resources. This was the distribution of quotas through market auctions, tenders and so on. All of this enabled us to secure some noticeable results. Some of them were secured by law, for example the law on states purchases, which requires orders to be put out to compulsory tendering. If one does not stick to this, corruption indeed becomes an unbeatable evil. Today there are no attempts to put orders out to tender, no bankruptcies, no parliamentary control, no laws. If the government itself is ignoring laws, then this evil becomes unbeatable.

Gaidar

When Glaziev worked for the government, he indeed did a lot to introduce tenders into foreign trade. This market device was very useful in fighting corruption, and it is very disappointing that it is neglected now. We shall be drafting a law on state purchases and a decree on buying quotas — all very important. Only I'm less optimistic than Glaziev. I'm not convinced that those who were appointed later, took less.

Victor Sheinis (Duma Deputy)

But is it not logical that when fighting corruption depends on a civil servant, even a high ranking one, no-one wants to fight corruption?

Glaziev

I agree. And I would like to answer Yegor Gaidar. As soon as the rules of the game change, people start to act differently. The Supreme Soviet disappeared, the government changed, the principle of personal loyalty became the guiding principle in politics, and those who thought differently became outsiders. I noticed that some of those I appointed very quickly sank to the level which forced me to sack their predecessors.

Leonid Gordon (IRIS)

What I would now like to see is a consensus on the existence of social pre-conditions of corruption. One must understand that it takes more than sacking officials to fight it. This aspect has strategic significance. If we bear in mind only the narrow technical-economic problems, then stabilisation can be achieved with a sensible project and certain luck in two-three years. But if one bears in mind social factors, then it will take several generations. I'm convinced of that, but if we continue thinking that we can do it in two years, these generations will live very badly.

Polishchuk (IRIS)

Among undeveloped markets in Russia, the market of corporate management was not mentioned, which otherwise should provide efficient management of private enterprises, consideration of shareholders' interests, decent salaries and prevent market-contrary decisions, all of which are necessary for structural reform. Not everything is well in this sphere, and this is the result of an insufficient amount of bankruptcies, of the difficulty of replacing opportunistic

managers, etc. My question is this: can one expect that corporate management in Russia will develop spontaneously, as the result of large-scale privatisation, or should there be state-led economic policy?

Chapter Five. Speeches: Chubais, Livshits, Skidelsky

Anatoly Chubais

In my opinion the first quarter of 1995 has been the turning point in the economic reform programme. It was preceded by a period of extreme economic, financial and political difficulty. For example, inflation rose to 20 per cent a month in December 1994. The situation in the foreign currency market was quite catastrophic: at the start of January there was a period when foreign currency reserves were within three days of exhaustion. Naturally, the situation was made worse by politics. The events in Chechnya broke confidence in the possibility of any kind of financial stabilisation. These dangers led to strategic changes in economic policy, notably a series of liberalising and stabilisation measures taken in January-March 1995.

The most important liberalising measures were as follows. First, we abolished quotas, licences, and export grants. As a result, almost one-third of the functions of the Ministry of Foreign Economic Relations and the people who mostly performed them disappeared. Not least important is the fact that these measures undermined the sources of corruption in the Russian economy. Today exports are not regulated at all.

Secondly, we deregulated the oil sector. Proportional access to pipes was established, and the right to sell for export was granted to all producers irrespective of the volume of their domestic output.

Thirdly, an important, though not very visible, measure was the decision by the President and the government to liberalise more prices. The list of goods and services on which price ceilings and floors could be fixed on the federal as well as regional level was reduced from 15 to 7-8 per cent.

Finally, we abolished tax concessions on foreign trade. The volume of concessions in 1994 amounted to 6 trillion roubles. The scale of these concessions led not only to budget losses, but also deformed the structure of foreign trade in the country. For example, 95 per cent of alcohol and 98 per cent of tobacco were imported into the country by one importer only. Prices were distorted and the possibility of taxing domestic producers of alcohol was undermined. In March 1995 the system was completely abolished. These measures, in my view, profoundly transformed the incentive structure of the Russian economy.

Turning to stabilisation, it is essential to recall the problem of setting a budget for 1995. In the autumn 1994 the draft budget was considered

absolutely unacceptable by the whole Parliament — right, left, pink, other colours. And for this there were specific grounds. I shall consider the principal elements of the budgetary strategy.

The first goal was the reduction of the budget deficit. In 1994 the budget deficit was 10 per cent of GDP. In 1995 our plan was that the budget deficit should not exceed 5.5 per cent of GDP. The second element in the budget strategy was the rejection of inflationary sources of financing. In 1994 74 per cent of the budget deficit was covered by credits from the Central Bank. In 1995 credits from the Central Bank for the budget are set to equal zero. The 3.56 trillion roubles of credit by the CBR for smoothing out cash flows has to be repaid in six months: it is not a credit for covering the budget deficit. Therefore I am stating that there will be no financing of the budget deficit by the Central Bank this year. Acceptance of this budget was immediately reflected on the financial markets.

An important consequence follows from what I've just said. The Central Bank will not finance agriculture. All Central Bank credits to the agricultural sector will go. The Agrarian party asked for a minimum of one trillion roubles of centralised credit for harvesting. They will get nothing. In the first quarter of this year we managed to sharply raise taxes on the hitherto privileged energy sector. This too had an important influence on financial opinion.

As a result of this series of liberalising and stabilisation measures both the financial sector and the real economy experienced great improvements. It is widely known what has happened to inflation. In January 1995 inflation amounted to 17.8 per cent a month, in February it was down to 11 per cent, in March 8.9 per cent, in the first two weeks of April 3.7 per cent and in the next two weeks of April it will not be more than 4 per cent. The growth of the money supply in the first quarter amounted to 3 per cent altogether. As you probably understand, this predetermines a fall in inflation levels in the second quarter of this year.

Then consider foreign currency reserves of the Central Bank. In January we were on the brink of catastrophe, but at the end of January the situation was reversed. From the beginning of February onwards, there began a real growth of the foreign currency reserves of the Central Bank. In March this growth was very high. As a result we have serious problems with the excessive growth of the foreign currency reserves of the Central Bank as of April 1 of this year. I would say that the volume of foreign currency reserves accumulated by the Central Bank exceeds the figure which is laid out in the monetary programme of this year by 30 per cent. The result of this is

the gradual decline in interest rates on the credit markets: from 190 per cent to 160 per cent a year.

There had been no significant change in industrial output: production declined by 3 per cent in January and 2 per cent in February. However, it rose by 6 per cent in March. In general, Russia certainly faces a very difficult future. Debts to defence factories are growing dramatically; household incomes continue to be very low, having declined by more than a quarter in real terms; agricultural production faces a dramatic fall. On its negative side, declining inflation will bankrupt some firms and banks. Unemployment will worsen, particularly in some regions. There will also be seasonal fluctuations.

However, my conclusion is optimistic. I am convinced that we were never so close to deep economic recovery as we are now. Legal efforts are pending regarding shareholders' rights, such as the law on Joint Stock Companies, which I hope will be passed before the end of this year. Combatting the mafia, which greatly jeopardises shareholders' rights, is partly a legal problem, and with the intended legislation it could be on its way to being resolved. There are now no strong grounds for doubting the durability of the regime or its determination to proceed with the reforms.

Alexander Livshits

In principle, there are no disagreements between the Presidency and the government in analysis of current events. This year there have been no more troublesome days than 6-10 January when only with great effort was it possible to halt the collapse of the currency market. Banking institutions and financial trusts have started investing in the Russian economy. This is a truly novel occurrence, probably the first note of confidence in the policy of the government.

I would like to discuss the threats awaiting us on the way to financial stabilisation in 1995. One is the difficult situation in the defence sector. We thought 1994 catastrophic, but the Ministry of Defence thinks that 1994 was not bad compared to 1995. Four other factors threaten stabilisation.

The first is the adaptation of economic agents to a stable, low level of inflation. Much of the economic behaviour since 1992 grew up in conditions of high inflation, adapted to it, and is unfamiliar with any other type of economy. In banking institutions there are many 'gourmets' who are used to exotic dishes with three-figure interest rates. It will be difficult for them to get used to simple, but healthy food which we are about to offer in mid-year.

Another worrying problem is the co-ordination between the government and the Central Bank. The situation is not cloudless, but not particularly grave either. However, a fact is a fact — the law on the Central Bank entered its last lap towards the finish. After its ratification, a President of the Central Bank shall be appointed who will have to work within a pre-determined financial framework. A technical detail arose during the final discussions on the law on the Central Bank concerning the Board of Directors, in particular the fact that the Board Members shall be presented to the State Duma by the President of the Bank only after consulting the President of the Russian Federation. Thus a system of interaction develops which may weaken the Bank's foreign currency reserves.

The third factor is the condition of financial markets. We don't yet have systematic market regulators. There are multitudes of unruly claimants for money: local authorities distribute loans irrespective of the actions by federal authorities; financial pyramids are formed. The financial market must retain stability throughout the whole year, otherwise the budget will suffer.

The fourth factor is very strong pressure on the Government following the President's directives No. 226 and No. 244 on budget discipline and the abolition of tax concessions on foreign trade. The pressure is manifold, and is very powerful. Fortunately, the main pressure is not to abolish these directives, but to search for ways round them. But there are examples of direct pressure as well. One institution, expecting the appearance of the directive No. 244, had just before secured contracts worth 2 billion dollars, thus ensuring non-taxable profits. The danger here is that, if there is a retreat from these directives, strong inflationary expectations will threaten with all their ensuing consequences.

These are the four principal factors threatening stabilisation. I would like to emphasise again the importance of adapting to a new situation. I do not regard politics as so much of an obstacle this time round. Political resistance may build up as the consequences of the programme start to take effect, but we think we shall be able to deal with it.

Robert Skidelsky

I would like to relate my remarks more closely to Professor Olson's presentation than some speeches have done, because, as a foreigner, I feel it is indelicate to comment too directly on domestic Russian affairs. Professor Olson offers a theory of a 'stationary bandit economy'. The practical task to which such an analysis points is how to decriminalise the economy — how to reconstitute the state as an effective agent of reform without restoring the stationary bandit.

A rational stationary bandit, Olson says, will take only part of the population's incomes in taxes, so as not to kill the goose which lays the golden eggs. The stationary bandit, mafia chief, warlord, whoever, settles down, assumes the crown, and provides the public good of peace and security which secures his long-run tax take. In my own paper (see Chapter Six) I contrast the notion of a 'revenue' economy with that of a market economy. In a revenue economy, wealth flows from producer to ruler: the ruler confiscates the surplus of the producer for his own purposes, leaving him enough to live on, like the stationary bandit. In a market or trading economy, wealth circulates between subjects of the ruler and increases through the effects of the division of labour and accumulation of stock described by Adam Smith. In a market economy, the ruler's revenues are limited to those required to provide necessary public goods.

Olson shows that the rational stationary bandit will not confiscate the whole of his subjects' wealth: he will limit his take to what is needed to maintain the income of his territory, and thus his own future income.

But Olson is surely wrong to think that the rational stationary bandit is a revenue maximiser — someone whose interest it is to increase rather than just maintain his revenues. The rational autocrat has a strong incentive to remain autocratic. This will lead him to preserve his discretionary right to expropriate his subjects' property. He thus has no incentive to establish secure private property rights. Thus the rational autocrat will limit his tax-take to the amount necessary to preserve his tax base but not to the amount required for economic growth. He will continue to draw monopoly rents, unless he is subject to external constraint, i.e. ceases to be an autocrat.

This seems to be borne out by history. All traditional revenue economies were static, even though the great bandit families like Manchus or Moghuls converted themselves into imperial dynasties. The Stalinist economy, which is their 20th century equivalent, was not static, but its growth rate was grossly exaggerated: over the whole period 1917-1991 there was no

catch-up with the West, and it started to decline as soon as more than mobilising resources was required of it.

Historically, external limitation on the ruler's power to tax seems to have been a necessary condition of long-run economic growth. Two of these limitations are historically significant: private property rights enforced by law, especially against the ruler; and a constitution under which the ruler can obtain revenues only with the consent of property owners. There also seems to be an optimum unit of protection, though it is hard to say what it is. If the area is too small or too large, costs of protection rise. The Manchu and Moghul empires suffered from diseconomies of scale, as no doubt did the Soviet empire. It was the establishment of conditions limiting the ruler's tax-take in the medium-sized nation states in Western Europe in 17th and 18th centuries which started economic growth.

In the 19th century the state's tax-take as a share of national income declined in practically all countries, despite a wider revenue base. In what are now the OECD countries it fell to under 10 per cent by 1880, which was much lower than in pre-industrial times. (It is estimated that up to 70 per cent of the cultivator's produce was taken for various forms of 'protection' in 17th century India.) A key feature of the political economy of the 20th century has been the return of the revenue economy. The share of resources taken by the state, and of state spending in the national income rose steadily in nearly all developed countries from just before the first world war till the 1980s, most extremely of course in the communist countries.

The 20th century state has demanded extra revenue on three main grounds. The first is traditional: the rising costs of protection. Twentieth century states have spent far more on armaments than 19th century states, none more than the Soviet Union. They have claimed that the world is less safe than it was in the 19th century: but arms spending and the trade which accompanies it have helped make it less safe.

The second was to promote economic development. The state claimed that if it did the investing the economy would grow faster than if this was left to the capitalist class and market forces. As Olson said, this claim was carried to its extreme by Stalin, but practically all 20th century governments have undertaken sizeable tax, or bond — financed investment programmes.

Finally, the modern state has raised revenue to redistribute it to the poor — it became the welfare state. It was the acquiescence of property owners to these last two extensions of state functions which enabled a decisive expansion in state revenues to take place. Intellectual conviction and

conscience may have played some part in this acquiescence. More importantly, a franchise in which the property-less were in a majority no longer offered a barrier to the expansion of state functions which the property-based franchise of the 19th century had imposed.

Thus we may say that the stationary bandit reinvented himself as the development state and the welfare state. The most radical expression of these claims was in Marxism-Leninism; but even in capitalist countries the state's share of taxes and spending has risen to 30-50 per cent of GDP.

The key question is whether the 20th century revenue economy is a genuinely new form of economic life, or only the old stationary bandit dressed up in more attractive clothes. A number of differences seem to be crucial. The first is that the claim to revenue is now justified by appeals to welfare, and this must have some effect on how state revenues are distributed. Secondly, the modern state has claimed, against the market, the capacity for large-scale economic calculation. In its extreme form, again in the Soviet Union, this became the proposition that the state is the uniquely rational actor in the social and economic universe. The third claim is that the modern state, unlike the stationary bandit, is constrained by democracy to spend its revenues according to the community's preferences, not the ruler's private preferences.

I doubt if these distinctions amount to real differences. Once we reject the claim that unique rationality lies in the state — as I think we must — the issue boils down to whether modern rulers are forced to spend their enlarged revenues in ways the community wants them spent. Obviously there was no such compulsion in the Soviet system. Stalin and his successors were stationary bandits, not democratic rulers. Nevertheless, theory and experience shows that even in democracies rulers have great latitude to spend their revenues as they (or their staff) want. The main reason is that when voters choose governments they do not also choose specific objects for governments to spend money on. Even if this political defect could be overcome, there is no way aggregate spending programmes can be tailored to the individual preferences of millions of people, except perhaps the very poorest. Thus there will always be a gap between how governments spend taxpayers' money and how individuals would have spent it themselves had they not paid the taxes. This gap, which causes few problems if governments confine themselves to their traditional law and order and charitable functions, becomes politically and economically significant the more of the national income the state spends, and the more taxpayers there are in the population.

Thus it may be that democratic legitimation only postpones the crisis of the revenue economy. Even the once vaunted Swedish model of social democracy succumbed to the preference gap between rulers and subjects. This is the insoluble contradiction of the revenue economy. As Olson puts it, economic arrangements contrary to market preferences require coercion, so that suppressed criminality, like suppressed inflation, is endemic in revenue economies.

The crisis of the revenue economy is signalled by the emergence of tax resistance. Olson points to the tendency for the autocrat's tax-take to decline: in the extreme case, where the autocrat takes almost everything, almost everyone has an incentive to collude with others to take back or withhold what is owed: the system becomes fairer, but the centre runs out of money. This is a good stylised account of the breakdown of the Stalinist system once coercion was softened. And it explains the breakdown of most autocratic empires throughout history. It also explains the 'fiscal crisis' which hit nearly all welfare states in the 1970s and 1980s. Soviet Russia exhibited in extreme form pathologies which struck all revenue economies, because, as Olson said, it developed the system of confiscation to an extreme degree.

There are many forms of tax resistance, but there is a single principle behind it, which is to place some portion of wealth or income earning activity beyond the scrutiny of the tax collector. In India the favoured traditional method was to hoard precious metals — to the great detriment of its economic development. Or fiscal separatism or fragmentation may develop; or the informal economy may expand. The essential message being conveyed by tax resistance is that the taxpayers do not wish to buy the state's output at the prices which the state charges.

It is impossible to identify a single tax/income ratio at which tax resistance develops, valid across all societies and at all times. It depends on the efficiency of the tax collecting system, degree of respect for the law, the efficiency with which state services are provided, historical tax tolerance, and so on. The perceived gap between costs and benefits may develop at quite low levels of taxation, if the services the state provides are of very poor quality, and then a vicious circle of declining public services and declining tax revenues may easily develop.

But a very crude indicator that this ratio is too high is the emergence of price inflation. As the economist John Maynard Keynes emphasised, inflation must be understood as a form of taxation. It is the form of taxation which is most difficult to evade, which even the weakest government can

enforce, and to which governments resort when they cannot live in any other way.

The only way that individuals can avoid the inflation tax is to flee the currency. Russians have reacted to the inflation tax by buying dollars. This very rational response has had at least three bad practical results. First, it is far more difficult for the government to use the population's savings to finance the budget deficit.

Second, widespread dollarisation makes attempts to formalise and measure Russia's largely informal economy almost insurmountable. Measuring the economy is a prerequisite of levying taxes legitimately.

Finally, dollarisation — and the associated capital flight — lowers the funds available for domestic private investment.

This brings me to one of the main topics of this conference, whether high inflation has monetary or structural causes. I would say high inflation is the monetary expression of the imbalance of demand and supply in the market for tax-financed goods. We have to understand that the Russian consumer is being taxed to pay for goods he does not want. The inflation tax is the mechanism by which government transfers real resources from the general population to particular clients of the state, and thus removes any incentive for them to restructure. Thus the key requirement for raising the general standard of living is to abolish the inflation tax. Economic stabilisation — ending credits from Russia's Central Bank and thus ending inflation — is the best form of social policy.

My final thoughts are these. The West has a very important stake in the outcome of the transition in Russia, simply in terms of its own self-interest. There are vast opportunities for complementary exchange. You are rich in energy, we are poor in energy. You are short of capital goods, while we have a surplus capacity. We both have highly skilled labour forces. Our hopes of a better world, as well as, yours depend crucially on the reopening of the trade frontier closed off in 1917.

Apart from specialised assistance, the West can do two things which I have consistently urged. The first is to drop the plan for the eastward expansion of NATO, which only adds insult to injury without improving the security of the proposed new members. Let us develop a proper European security system, of which the new Russia should be an integral part.

Secondly, we in the West must aim to conduct our economic policies in ways which help and do not hinder the creation of a liberal trading and

payments system. We cannot ask you to abandon your system of protection if we stop the entry of your goods and services. We must jointly try to recapture the vision which inspired the Bretton Woods system of 1944. Today's choices are hardly less momentous.

I make my last point with some hesitation, and with more of a sense of being impertinent. I have listened with enormous interest to the presentations of Messrs Gaidar, Yavlinsky and Fedorov. Why is it so difficult for the liberal forces in Russia to unite? To an outsider the points of disagreement seem insubstantial compared to the values all three share. Unless they unite, come the elections, the differences will hardly matter — the pro-market cause might lose all influence in the Duma.

This point is not just political, but analytical, and brings me back to Mancur Olson. In his theory of collective action, a political party is a classic example of what he calls an 'encompassing group' — that is, one capable of taking a broad view of the national interest. But the Duma has no political parties — only a collection of factions.

This places almost sole responsibility for articulating and representing the general will on a single individual — the President — with the political factions left free to pursue narrow interests of their own.

I feel the Presidency is too slender a reed to carry the whole burden of reforms. Perhaps I speak out of place. But I think most people would agree that had the reformers been united in the December 1993 elections, there would have been more consistent backing for reform than has been available from the current Duma. So I hope this conference will not neglect the importance of establishing democratic political parties as a crucial element of a durable economic reform programme.

PANEL COMMENT

Richard Layard: Can Russia Beat The Mafia?

The mafia are a real problem. There is the big mafia, who have made huge fortunes through control of trade in oil, metals, cars and (more recently) drugs. And there are the local mafia who control retail trade, construction and repair shops — making sure that new entrants either pay up or keep out. Every day you hear of the new businesses jeopardised by the restrictive force of the mafia.

Are the mafia in Russia to stay, like in Sicily? Or are these problems just a feature of transition?

Though corruption flourished under communism (often backed up by force), things have become steadily worse since 1985, and this is easily explained. The main reason is not the decline of police power (which is more a symptom than a cause). It is the ending of state monopoly of jobs and property.

Under communism there was one employer so you had to behave otherwise it would be very difficult to get a satisfactory job. The state monopoly of jobs meant that, for a successful career, you should follow the Party code; if you got caught, there was nowhere outside the system to go. This was a strong sanction for good behaviour.

The state monopoly of property meant that there was no private property and no private contracts. So there was no problem of protecting your property, or of enforcing a contract on someone who owed you money.

As communism fell, both of these situations changed with the same results as in Sicily in the mid-19 century, when the feudal system gave way to individual land-holding. As private property proliferated, there was a demand for people to protect property and to help collect debts. In addition there was in Russia, as in Sicily, an ample supply of people with good military or para-military training, willing to earn money from providing protection.

The answer to the mafia is, of course, for the state to supply the protection. A law-based society is one where the state has the monopoly of force, and where there is a working system of law courts. Now that the state monopoly of jobs is gone, the legal system has to be the main sanction enforcing good behaviour.

Can the state rise to the occasion? There is some evidence that shopkeepers increasingly use the police rather than the mafia to protect them because they charge a lower fee, their protection is more dependable, and there is less chance that they will arbitrarily increase the fee. This is exactly what is needed. The police is gradually re-establishing its superior force, by buying better equipment and paying its officers better.

Sicily never threw off the mafia, but in Russia there are two grounds for hope. First, many problems which nourished the growth of the mafia were transitional and short-lived, such as the problem of the black market during perestroika. This developed from the attempt to fix prices at below market-clearing levels. The incentives for illegal selling at higher prices were enormous, and the mafia determined who made these gains. More recently, the existence of an over-regulated economy with export quotas and other licenses created the possibility of huge 'rents', and again the mafia entered as the organisation which determined who got the proceeds. For example, there was a huge incentive to smuggle out metals and oil bought in Russia at one tenth of world prices. Estonia became the world's leading net exporter of non-ferrous metals, even though she produced none herself. Protection of these illegal export routes was an important field for mafia activity. Today, however, licensing is in retreat and the black market stems only from tax evasion, as in any normal country. That is the first ground for hope.

The second is that Russia is becoming a more settled society. In settled societies people take more care to build solid reputations than they do in unsettled times. In unsettled times the natural thing is to make your fortune by a quick act of robbery. In more settled times you need a sound reputation for a steady income. As Russia becomes more settled, this will become a dominant influence. Those who made their fortunes by robbery already want to develop reputations for more respectable practice, and they want a strong legal system which will protect the property which they previously stole.

GENERAL DISCUSSION

Layard

Skidelsky seems to me to underestimate the difference between the stationary bandit and the democratic state. The Stalinist state and the Welfare state were very different animals.

Skidelsky

I agree with Layard that the democratic process provides for popular influence over rulers' choices. I can't imagine democracies voting in a Stalinist economy. But my point is that tax resistance eventually develops, in democracies as well as autocracies, if rulers try to spend too much of their citizens' money. The exact point at which tax resistance develops is a matter about which you can't generalise very much.

Galina Staravoitova (Duma deputy)

I would like to ask Lord Skidelsky a question concerning his proposed relations between Russia and the Western countries. One hears often that our relations could be established on the principle that Russia is gifted with natural resources and a highly qualified work force, and Western countries with the complementary capital and also a highly qualified work force. But capital is not a renewable commodity. Maybe both sides have prospects of developing technological and scientific co-operation. I'd like to know your opinion on what the prospects are for Russian entrepreneurs to enter the market of technological and scientific research. Because currently Russia does not have access to the academic and scientific programmes of the EU, even though some, which presuppose combined actions, do not require much expenditure.

Skidelsky

Russia needs to concentrate on her comparative advantages. This is the way to accumulate capital within Russia for domestic investment. Russia's advantage lies in energy and mineral resources, and as much as possible of these should be sold on world markets. On scientific and technological co-operation, that depends partly on how international relations develop. The better they are, the more natural this kind of co-operation will be. That's why I emphasised in my speech that the West should not exacerbate international tensions by extending NATO. We should regard the Cold War as finished. That is the most important basis of scientific and technical co-operation. On access to markets, the biggest obstacle at the moment is

high unemployment in the European Union. Whenever there is high unemployment there is a strengthening of protectionism. So you need a return to fuller employment in the West, in order to extend free trade to the East. The economist John Maynard Keynes said that the only way to develop a liberal trade and payment system was to have full employment policies. I still think there is a lot in that.

Layard

If we look at Spain which is a country that has come out of totalitarianism and joined the European Community, we see that there is need for capital and tremendous opportunities for capital thrown into Spain. What should happen in Russia is that there would be a flowing of capital from the West over a period of 20 years and more, which would be complementary to the highly skilled labour in Russia. I believe that as soon as sufficient financial and political stabilities in Russia are established, you will see the reverse of the capital flight which led 15 billion dollars out of Russia into foreign assets.

Question

Skidelsky expressed regret that the representatives of Russian democratic movements cannot agree among themselves despite their closeness. I'm afraid this is a natural process, and the reasons for it were mentioned at this conference. For the Russian population in general, and for certain groups in particular, it is vitally important to take part in the redistributive processes, and since many of these processes go through the state, it is important for these groups to be represented in the state power. The reasons for the inability of political forces to unite were also outlined by M. Olson in his book, The Logic of Collective Action. In order to unite, the assurance is needed that members of the same democratic movement will enjoy the fruits of victory to the same extent, provided the democrats could win such a victory. But if the democratic movement in Russia is disunited, the same is true for the conservative and communist movements. And as a result of this the outcome of the elections will be inadequate for the real expectations of the Russian population. One should by no means cancel elections because this would lead to the loss of faith in democracy in Russia, but the Committee [of the Duma — Ed.] says that elections should be postponed. I think the strongest argument on their side is exactly that political parties do not represent political interests as such.

Question (Institute Of Economics At The Academy Of Science)

I have a question to Professor Skidelsky. Why do many Western experts believe that Russia's economic growth depends on capital investment? Maybe the recent lack of investment was not due to inflation, but to lack of aggregate demand.

Don't the very measures which are being taken to create conditions for investment, undermine the possibility of investment? There is the argument that banks have the population's savings, but one could reply that they are concentrated in the wrong sectors for investment, whilst the sectors which are able to increase consumption do not have the means for pay for the demand.

Question

Our Western colleagues have presented very interesting ideas concerning stationary banditry. We should dedicate much more time to thinking about this. I'd only like to add that we had not one general stationary bandit, but many bandits on lower or intermediary levels. We had bandits in industry and regions; there are still bandits in science. I have a sociological question to Professor Olson on his very interesting differentiation between a stationary bandit and a roving bandit. To that I would add another type of bandit: a stationary bandit with the psyche of a roving one, because this is the type that we've had. This probably changes your conception.

Skidelsky

First, why can't Russia develop a powerful democratic party? I think that the more the distributive role of the state, its control over national resources, and its responsibility for distributing credits and finance declines, the greater the chance there will be of developing Western type political parties. Economic and political reform go together. But still there are personal rivalries not just economic ones.

The second question has to do with the state of confidence. In a high-inflation situation stabilisation is a prerequisite for the recovery of investment. In other words, in a high inflation situation, the distinction between Keynesianism and monetarism disappears. It is only when inflation is low that the argument on priorities starts.

As to the third comment about the existence of lots of stationary bandits, I completely agree. This is a part of the deterioration of a system which starts with a single stationary bandit and then, as this single stationary bandit loses the coercive power, the national income is increasingly appropriated by the servants of the stationary bandit, the nomenklatura in this particular case. In the Moghul dynasty in India the tax collectors took ever larger shares of the agricultural product, the stationary bandit ceased to have any money to continue his rule, and at that point the centre disappeared. I think that something similar happened at the end of the Soviet Union. That process had obviously been going on for a long time in a suppressed or concealed way and finally became visible at the end of the Gorbachev era.

I think you can make a parallel with the end of the Roman Empire. It's a combination of two things: the external pressure, in the case of Russia the Reagan arms build-up which put an intolerable strain on the Soviet economy, and the declining revenue base as the centre lost its coercive power over resources. These two things brought down the system.

Question (Committee on Foreign Affairs, Federal Assembly)

Why do you think it is that in countries which are in transition to market economies, in particular Central East European countries, special attention is paid to developing small business, whilst in Russia the development of small business is being ignored?

Skidelsky

Mainly because in Russia resources are still being redistributed, via the inflation tax, to the ineffective sectors. Still, it's interesting to notice the revival of belief in small businesses, largely driven by microchip technology. In the 1950s and 1960s people believed that big is beautiful. Now small is beautiful. The new technology is much more favourable to the market system than the old, and that's why there has been this change over the whole world and not just in the former Soviet Union in the last 15 years.

Chairman (IRIS)

Anna Krueger, the former chief economist of the World Bank, who studied the transitions in both Korea and Turkey, found that within 10 years of the beginning of the transition, 80 per cent of GDP came through firms which did not exist at the beginning of transition. Thus it may not be so much a question of small versus large, but a question of new versus old.

Chapter Six. Comparative Perspectives on the Future Cohesion of the Russian State

by Peter Murrell

1. Introduction

After the unpredicted fall of the USSR, the catastrophic split of Yugoslavia, and the unexpected break up of Czechoslovakia, there has been no shortage of analysts predicting further state fissures in the post-Soviet world. Thus, Stern (1994) argues that Russia was never, and is not, sustainable as a state: we are heading for 'Moscow Meltdown'.¹

This paper argues that the reports of Russia's death are much exaggerated. The period of danger for the Russian state, if ever there was one, is over. Secessionist tendencies will abate over the forthcoming years and Russia will show increasing cohesion; as a result, Moscow's power will increase. I argue that there is a benign dynamic to politico-economic interactions in decentralized, market, democracies, even in one of a most rudimentary kind, as Russia is today.

The forecast of increasing state cohesion is consistent with the experience of secession and separatism after other great transitions. The experience of Spain is notable here, representing at the time of its transition from autocracy 'the classic case of a country locked into a permanent state of crisis because of the conflict between centre and periphery' (Blondel, 1981, p.319). With decentralization occurring in a period of economic crisis, there were great fears that the regions would use protectionist policies and destroy the unity of the national economy. Instead, regional autonomy combined with central policy to reinforce the integrity of the national economy (Barquero and Hebbert, 1985). Similar, though less dramatic stories can be told about the ebbs and flows of separatism in many other countries, such as Belgium, Canada, Australia, and Italy. Indeed, one of the major messages of the history of capitalist democracy for the Russian state is that separatism and inter-regional struggles are not unique to post-socialism, but rather are normal processes of stable, successful societies.

The following discussion concentrates on the politico-economic bases of secession and cohesion. I do not analyze ethnic and religious causes. These are important factors to be sure. Nevertheless, the significance of ethnic and religious tensions is unlikely to change radically over time. As yet they have not torn the Russian state asunder. In contrast, an important

consequence of the large political and economic changes during transition is a benign politico-economic dynamics that leads to increasing state cohesion. Thus, while no rational politico-economics can negate the worst pathologies of ethnopolitics — of a Russian Milosevich or Tudjman — there are reasons to hope such pathologies will not be the dominant factor in the future.

2. General assumptions

The view of democracy employed here assumes that politicians are forced to react to the deepest and most important concerns of a nation's citizens. Even in a highly imperfect democratic environment, as in Russia, policy has to respond to the balance of interests and power in the country. This is not to say that policy maximizes social welfare, but rather that policy avoids the worst disasters. It is a view consistent with the observation that no major famine has ever occurred in a democratic country and that no democratic country has ever declared war on another.

Democratic governments must be especially responsive to regional interests, because geography is one of the most natural bases for interest articulation and for interest group formation. Hence the balance of power between regions is influential in determining policy. The regional balance of power is affected by two important factors. First, there is the relative economic strength of a region.² Thus, the richest regions often have decisive influence over whether secession occurs. For example, the precipitating event in Czechoslovakia was the Czechs themselves becoming separatist, in reaction to the Slovaks. Similarly, it was Slovenia and Croatia which triggered the split of Yugoslavia. The second factor affecting the power of a locality is its participation in national politics, which is inversely related to the locality's secessionist stance.³

Decentralization helps ensure that the centre must be responsive to real regional interests. It is political decentralization that provides the basis for local interest articulation at the national level. It is economic decentralization that leads to strong inter-regional differentiation, which makes central responsiveness to localities both necessary and productive. Perhaps, the most profound example of the effect of decentralization on the formulation of central policy has appeared in a non-democratic context: the way in which Chinese economic reforms have been secured by the strongest economic regions (Kang-Chen, 1990). Thus, the deepening decentralization that is occurring in all post-socialist countries need not be a harbinger of chaos, but rather a precursor of increasing cohesion.

3. Complementarities between central and local policies

Market systems work best with an appropriate division of labor between central and local authorities. The strength of local government is a mark of developed economies (Oates, 1993). Under these conditions, there is a great complementarity between central and local policies. When the centre is conducting market-based pro-growth policies, the use of analogous policies at the local level promises large rewards. This is especially the case in transitions, where the range of policy changes that must be enacted is immense and there is large room for inconsistencies between policies at the two levels. The Spanish example is again instructive. Central policies have been directed towards correcting the macroeconomic imbalances and building the basic economic framework while the regions are able to work within this framework, to pay attention to issues that are of special importance to them. Protectionist measures have been renounced by the regions, the initiatives of the autonomous regions supporting national economic policies (Barquero and Hebbert, 1985).

Conversely, intelligent central policies mean little if they are accompanied by poor local policies: for example, free markets mean nothing if accompanied by local price controls. Corsica provides an interesting example outside the transition context. It enjoys considerable autonomy and a special status inside the French state. But its politics are dominated by clans and clientelism, implying that the huge redistribution from the centre is does not have a sustainable impact (Kofman, 1985). A similar story could be told for the Italian south.

On the other hand, a locality intent on doing the best for its citizens is virtually powerless if the central government undertakes policies inimical to growth. All a locality can do is distance itself from the centre, which in the short run is hardly productive because of the multiplicity of existing economic ties. The experience of the Baltic states in the last days of the Soviet Union and Slovenia during the demise of Yugoslavia show the futility of responsible attempts at local policy when the national government is incapable of implementing sensible policies.

4. The elements of policy interacting with separatism and secessionism

Because competition and the free entry of new producers are vital for economic success, there is a strong interaction between the quality of economic policy and the pursuit of separatism and secession. To create a strong economy, the central government must preserve the national economic space, ensuring the freest of trade between regions. It must have ultimate authority over the institutional, legal, and monetary environment.

Then, form must follow function in decentralization. For the good of all localities, central government must resist any secessionism that damages the integrity of the national economy. Thus, despite its unfortunate complexion, the subduing of Chechnya can be viewed as a necessary national economic policy.

Local policy should not threaten economic relations with the rest of the country. First and foremost, there must be no barriers to internal trade and there must be acceptance of the basic elements of national economic institutions and laws. For example, rejecting the parameters of a central privatization scheme, as was the case in some Russian regions (Slider 1994, p.378), simply places the country's property regime in future jeopardy. Similarly, in the long run, it will be counter-productive for regions to use threats of secessionism to obtain redistribution from the centre, as the dismal economic performance of Quebec clearly shows.

But there is still a great deal of room for differentiation of policy between regions. There are many areas of activity that do not need to be coordinated at the central level and that are better determined in response to local preferences. Thus, as Sergei Shakrai has noted, there are ample opportunities to solve ethnic problems at the levels of schools, media, religion etc.⁴

5. A summing up and a foreshadowing of the argument applied to Russia

Decentralization is a crucial element of modern democracy and modern economic development. However, the wrong types of decentralization — secessionism and separatism — are inimical to economic progress. Thus, the degree of separatism in local policies is a very important determinant of which regions are economically successful and which are not. When the center must listen to localities, the more successful regions have greater political power and greater influence over national policy. Hence, over time, political power becomes weighted in favor of those regions that are less separatist, thereby increasing the government's resolve to maintain the cohesion of the nation state.

We now apply this general argument to the dynamics of the transition in Russia. The transition process itself begins with a regime confronting immense economic problems and the task of building its own legitimacy, as well as retaining power. These facts in themselves would argue that the interaction between center and localities would shift dramatically over time, as a result of the developments wrought by the transition itself. The argument offered above indicates that there is every hope that this interaction will become more productive over time.

6. The beginning of transition

Immediately after a large scale change in a socio-economic system, the central government has attenuated incentives to implement forward-looking economic policies. Shocks to a system have an increasing returns effect, implying that there is some incentive to dampen the dramatic changes that are happening naturally, rather than to foster even more changes (Murrell, 1992). Successful policies require credibility, which is lacking because of the recent changes in system. Thus, in Russia, politicians as different as Shakrai and Dudaev have said that one real cause of regional problems is that the localities do not know whom they can trust.⁵ Additionally, the old distribution of income and of regional power still has the symbolic importance that often accrues to historical facts. Politicians are forced to strive to reproduce the old, as in 1991 and 1992 when Russian federal grants went primarily to the regions that lost income, not to the regions that were poorest.

Moreover, in times of crisis and falling income levels, more attention is paid to redistribution than to promoting growth. The vast changes in politics lead to local struggles (Shaw p.486 1993b) in which politicians view themselves as in an end-game, little interested in policies that only come to fruition after a few years. In this process, there will naturally be much dissension between regions. Thus, during the first year of Russian reform, regional associations tended to fall apart (Petrov, Mikheyev, and Smirnyagin 1992 p.59).

Under these circumstances, national politicians will find it hard to assemble a coalition of regions that are interested in growth-oriented policies, such as the preservation of the national economic space, stabilization, and liberalization. Then, rival politicians find it in their interest to vie for power by offering promises to regions, as was the case with Yeltsin and Gorbachev and then the Supreme Soviet and Yeltsin (Shaw 1993b p.533-4). Of course, the stories of Yeltsin's gifts to regions are legion. But perhaps most important of all, Yeltsin was only able to get a Federation Treaty signed in March 1992 by promising the republics special treatment in a large number of economic policy areas in which the federal government should be dominant (Langhammer, Sagers, and Locke 1992 p.618).

With central economic policy having such a complexion, the regions have every incentive to focus on redistribution from the centre, rather than implementing forward-looking policies of their own. Endemic local lobbying for subsidies ensues (Hanson 1994 p.24), with the threat of

secession used as an explicit strategy to lever more redistribution (Sheehy 1994 p.18). This occurs because the costs of secession are not high at such times. For example, had the security of federally-endorsed property rights been high, Tatarstan would have had much more to lose by introducing its own voucher program of privatization (Slider 1994, p.391), which cast a question mark over the system of property rights as a whole. And in turn, Yeltsin would have had much more incentive to back GKI against the regional authorities, rather than simply giving in as was usually the case (Slider 1994 p.395).

The piecemeal approach of central leaders to the regions produces a disconnection between local and national politics that puts reform-oriented local politicians at a disadvantage (Hanson 1994 p.28). This increases separatist pressures. For example, the separatist regions that resisted privatization were often the ones that obtained the biggest subsidies from the centre (Slider 1994, p.379). Many oblasts were ready to oppose the granting of special privileges to regions. But when these oblasts found they could not put a stop to these special privileges, they lobbied for their own special status instead (Dienes 1993 p.509).

Thus, it is misleading to characterize secessionist tendencies at the beginning of the transition as simply the product of ethnic differences and past resentments. In fact, these tendencies are a rational reaction to the policy environment that is almost inherent in the formation of a new political and economic order. In the initial chaotic state, a politico-economic equilibrium prevents productive center-local relations. The economic and policy basis of secessionist movements is naturally highest at these times. This was certainly the case in post-war Italy and post-Franco Spain. Czechoslovakia, Yugoslavia, and the USSR all split apart when their economic and political systems were under the great stresses of change brought about by fundamental regime shifts.

7. With the passage of time

Changes naturally occurring in the first years of transition alter the politico-economic dynamics. The new regime gains credibility by virtue of its survival. This leads to an increasing effectiveness in the implementation of central policy. (For evidence of such changes in many unexpected places, see the experience of the Ukraine, Romania, or Mongolia.) The mere passage of time implies a depreciation in the symbolic status of the old structure of power and of income distribution. Thus, redistributive policy can be more efficient and forward-looking. For example, Russian politicians

are now suggesting focusing the regional fund on poorer regions rather than on those that lost incomes in the move to the new system.⁶

At the same time, economic production stabilizes, simply as a matter of course, if not of policy. Forward-looking policies no longer have the disadvantage of increasing the shocks to the economy. Hence, the room for manoeuvre of central politicians is higher. With stabilization, local politicians can begin to look to the future, rather than concentrating on the redistributive struggle that inevitably occurs in a time of falling incomes.

There is also a sorting effect at the region level. Since the effects of local policies can now be observed, it will be increasingly possible for central politicians to know which regions are implementing productive policies, providing an important signal of which regions are likely to be more economically successful in the future. This provides the information for building regional support for growth-oriented policies at the national level. By allowing informed comparisons between regions, new pressure is brought to bear on local leaders who have not implemented productive policies. Thus, in 1994, Dudaev's Chechnya regime was beginning to face strong internal opposition in the face of evidence that other Northern Caucasus regions were faring much better (Mau 1995 p.7).

The consequence of these developments, as transition progresses, is that the changed incentives lead to the possibility of the country breaking out of the crisis-induced, redistributive, secessionist trap. There are forces that naturally lead to improvements in central government policy in the first few years of transition, especially as that policy involves interactions with the regions. There is less incentive to pander to secessionist forces, redistribution is reduced, and national policies are implemented with fewer concessions to specific regions. For example, budgetary subsidies in Russia declined as transition progressed; twelve important regions had their special foreign trade privileges removed in the beginning of 1995.⁷

Most importantly, there are enhanced economic returns from policies solidifying national institutions. This gives the centre an economic incentive to engage in actions that on the surface seem purely political. Thus, although the Chechnya war was costly in the short-run, it was an investment, a gruesome one, that will yield long-run benefits by signaling that national unity will be defended. In a similar vein, Yeltsin resisted demands of the putative Urals Republic at considerable short-run political cost. Although hardly democratic, Yeltsin's attacks on non-supportive local governments (Wishnevsky, 1994, p.13) can be cast in the same light.

The incentives of local politicians change also. As central policies become more growth-oriented, there is an increased pay-off to the localities from becoming players in the national arena rather than spoilers. Thus, the mercurial leader of the Republic of Kalmykia, Kirsan Ilyumzhinov, allied his republic with the concept of national unity in early 1994 (Sheehy 1994, p.18). The Federal-Tatarstan treaty was signed in February 1994 and the Tatar President supported Yeltsin later in that same year.⁸ Similarly, in other countries, the secessionist problems caused by Transdnestr in Moldova, Abkhazia in Georgia, and the Crimea in the Ukraine have all moderated in the last year.

8. The benign politico-economics of regional differentiation

The processes identified in the previous section are simply the beginning of a much longer progression, which is mostly yet to come in Russia. Because of the complementarity between central and local policies, as central policy improves the effects of good local policies will be enhanced. Given the economic damage wrought by separatist policies, there will be more incentive for the regions to conduct non-separatist policies.

More importantly, the effects of good and bad policies in different regions begin to bear their fruits and regions will exhibit markedly different levels of economic performance, reflecting the quality of local leadership. Already such differentiation is having its effects, with the 'socialism in one locality' of Ulyanovsk losing influence compared to the forward-oriented policies in Nizhny-Novgorod.⁹ These differences will become even more pronounced as the central government implements better policies at the center. Given the economic costs of separatism, the regions that have concentrated on separatist policies will be the losers.

Hence, there arises a very important political dynamic. The evolving structure of political influence within the country as a whole will reflect the configuration of economic success and failure. The regions that have concentrated on sound economic policies will now have more influence over national policy, because of their rising economic power. There is a feedback effect on national policy; the central government, given the configuration of regional economic power, will have even more incentive to implement productive policies and to move away from redistributive ones that pander to separatist interests. The state continues to solidify.

At this point in the argument, there is no scope for offering examples from Russia, because such developments still lie in the future. But in this politico-economic dynamic there lies the potential for a real solidification of the Russian state.

9. Concluding comments

Those who have predicted the demise of the Russian state have been led astray by the evidence emanating from processes that occur naturally at the start of transition. The above argument establishes that secessionism and separatism are at their highest on the birth of a new regime, with the natural politico-economic equilibrium having high levels of secessionist threats, the pandering to separatists by the central government, and signs of fissures in national economic structures. But just as these are natural tendencies at the beginning, there are also natural processes that tend to weaken them over time. Gradually, the incentives of the players begin to change so that there are much stronger inducements to enact policies that cement national unity. Russia has passed the dangerous phase and the cohesion of the nation will increase in the future.

References

- Barquero, Antonio Vasquez, and Hebbert, Michael, 'Spain: Economy and State in Transition', in Ray Hudson and Jim Lewis, eds., *Uneven development in Southern Europe*, Methuen, New York, 1985.
- Blondel, J., 'Political integration and the role of political parties: the case of Spain', in Torswick, P., ed. *Mobilization, Centre-periphery Structures, and Nation Building*, Bergen Universities, forlaget, 1981.
- Chen, Kang, *The Failure of Recentralization in China: Interplays Among Enterprises, Local Governments and the Center*, Policy Research Department, The World Bank, Research Paper Series No. CH 6, October 1990.
- Dienes, Leslie, 'Economic Geographic Relations in the Post-Soviet Republics', *Post-Soviet Geography*, 1993, 34, No. 8, pp. 497-529.
- Hanson, Philip, 'The Center Versus the Periphery in Russian Economic Policy', *RFE/RL Research Report*, vol. 3, No. 17, 29 April 1994.
- Kofman, Eleonore, 'Dependant Development in Corsica.' In Ray Hudson and Jim Lewis, eds., *Uneven Development in Southern Europe*, Methuen, London, 1985.
- Langhammer, Rolf J., Sagers, Matthew J., Lucke, Matthais, 'Regional Distribution of the Russian Federation's Export Earnings Outside the Former Soviet Union and its Implications for Regional Economic Autonomy', *Post-Soviet Geography*, 1992, 33, No. 10, pp. 617-634.
- Mau, Vladimir, 'Yeltsin's Choice: Background to the Chechnya Crisis', *Social Market Foundation Memorandum*, No. 12, February 1995.
- Mikheyev, S. S., Smirnyagin, L.V., Petrov, N.V., 'Russia's Regional Association in Decline,' summary reported in *Post-Soviet Geography*, 1993, 34(1), 59-66.

Oates, Wallace E., 'Fiscal Decentralization and Economic Development', *National Tax Journal*, Vol. XLVI, No. 2, 1993.

Shaw, Denis J.B., 'Bids for Autonomy by Northern Regions of the Russian Federation', in *Post-Soviet Geography*, 1993a, 35(5), 1993, pp.319-321.

Shaw, Denis J.B., 'Geographical and Historical Observations on the Future of a Federal Russia', *Post-Soviet Geography*, 1993b, 34, No. 8, pp. 530-540.

Sheehy, Ann, 'Kalmyk President Renounces Sovereignty of Republic', *RFE/RL Research Report*, vol. 3, No. 22, 3 June 1994.

Slider, Darrell, 'Privatization in Russia's Regions', *Post-Soviet Affairs*, 1994, 10, 4, pp. 367-396.

Stern, Jessica Eve, 'Moscow Meltdown Can Russia Survive?', *International Security*, vol. 18, No. 4 (Spring 1994), pp. 40-65.

Wishnevsky, Julia, 'Problems of Russian Regional Leadership', *RFE/RL Research Report*, vol. 3, No. 19, 13 May 1994.

Notes

¹ This is not simply a Western phenomenon, Russian analysts participating also. See, for example, the article by Alexander Ignatenko in *Kommersant Daily*, September 17th, 1994 as reported in FBIS September 9th 1994.

² For interesting examples, note the shift in power in Belgium to the Flemish regions and in Canada to the Western regions, as relative economic power changed in these countries.

³ Witness the waning political power of Quebec in Canada.

⁴ In *Argument i Fakty* as reported in FBIS-SOV October 24 1994 p. 28.

⁵ See FBIS-SOV October 24 1994 p. 28 and August 15 1994, p. 27.

⁶ FBIS-SOV August 15 1994 p. 26

⁷ FBIS-SOV April 6, 1995.

⁸ FBIS-SOV September 20, 1994.

⁹ *Economist*, March 25, 95 p. 54.

Chapter Seven. The Collapse of Communism: the Political Economy Context

by Robert Skidelsky

1. Introduction

The collapse of Soviet Communism is part of a number of different histories. The most familiar is the history of the Cold War which has a satisfyingly simple ending: the West won. A second is the history of ideology which also has a reasonable satisfying conclusion: freedom triumphed over totalitarianism. Coming closer to our theme, we may say that capitalism outlasted communism. The leading feature of these histories is that one side beat the other.

Francis Fukuyama's conclusion seems to hold for all these endings. There is only one ideological game in town: market capitalism and liberal democracy. While localised ethnic strife may erupt, a revival of the totalitarian 'isms' is not to be looked for.¹ This conclusion needs to be amplified and qualified. Not only has Communism collapsed, but the socialist and autarkic parts of capitalist economies have been or are being privatised and opened up to competition. This, as much as the collapse of Communism, makes the political economy landscape seem much flatter.

This double movement suggests that the collapse of Communism needs to be seen as the extreme or limiting case of a more general retreat from *collectivism* which affected all parts of the world at roughly the same time. All economies are in a state of 'transition'.

At the same time, at no point has there been a 'single' model of capitalism. This should alert us to the possibility that a liberal, free trade capitalist system is not an inevitable outcome of the double transition. The great contribution of Hayek and post war German social market economists was to remind us that a market order has to be *designed*. If its constitutional and political foundations are neglected, collectivism creeps back in many persuasive and winning forms. Much attention needs to be paid to 'constitution of liberty' to consolidate the world-wide gains of economic and political freedom.

There are two broad perspectives for grasping what has happened in the last fifteen years. The first focuses on role of state in economic life; the second on the connection between forms of political-economic

organisation and technology. Both are needed. My thesis is that the pathologies of the late 20th century collectivism produced not just a political and intellectual reaction against state-led predation, but also the technological reaction by which economic life could escape from what Mancur Olson calls 'institutional rheumatism'.²

2. Collectivism and technology

In the 20th century, the state has been extensively engaged in shaping economic activities. This reversed the 19th century trend to laissez-faire. Some aspects, at least, of the modern state's role hark back to earlier times when the wealth of subjects and foreigners was considered fit for rulers to command at will, for their greater power, glory and prestige.

These earlier economies were what Sir John Hicks calls 'tribute' or 'revenue' economies — support systems for the ruler and his servants. Market economies grew up on the edges of revenue economies, and eventually engulfed them. In the 20th century there has been a 'massive swing-back towards the Revenue Economy', though one 'profoundly transformed by experience of market forces'.³ Two aspects of this transforming experience of market forces may be noticed: first, a shift in economic focus from wealth seizure to wealth creation; secondly, a massive increase in the organisational capacity of the state, including its power of economic calculation. These innovations enabled the revenue economy to be transmuted into the collectivist economy. The state's claim to revenue is now based on the promise that it will be used to increase wealth and welfare.

Collectivism may be defined as the doctrine that the state knows best. The degree of collectivism may be measured by the extent to which resources are allocated and rewards distributed outside the market by 'public' (i.e. political or administrative) choice. Under Soviet Communism collectivism in this sense was total. Its charter promise was that central planning of a publicly-owned economy would allocate resources more efficiently, cause them to grow faster, and distribute them more justly than could a privately owned market economy. But to some degree all capitalist states became collectivist too.

A connected issue concerns the relationship between forms of economic organisation and the technique of production. Galbraith and many others have claimed that the state's role is determined by technology.⁴ Specifically, Galbraith argued that mass production industry required public planning and a large volume of state orders to guarantee its markets. He believed that Soviet Communism and American capitalism would converge on moderate

planning. Sverdlovsk and Detroit were twin manifestations of the same engineering civilisation. Today they are rusting away, twin victims of the microchip revolution. It is tempting to argue that the global revival of market forces since the 1980s has been driven by the requirements of the new miniaturised technology. The reality is more complicated. Although technological innovation is — uniquely — built into market-based capitalism, the timing of technological application is partly dictated by political and economic events. The escalation of energy and labour costs in the early 1970s made large swathes of capitalist enterprise unprofitable. Once the state renounced inflation, capitalism literally had to invent itself out of trouble. In the Communist empire, where energy and labour costs were under much better control, the application of new technology could be postponed for longer, with eventually devastating results. An open society can invent cures for its diseases. A closed society collapses, because while it can maintain its stability longer, its accumulating contradictions can be resolved in no other way.

3. Points of re-entry for the Revenue Economy

The idea that society might be organised to create wealth came with the birth of economics. But from the start there were two different two views about what role the state should play in wealth-creation. In his *Wealth of Nations* (1776), Adam Smith argued that the source of economic growth lay in people's 'natural propensity to truck, barter and exchange'. By promoting the division of labour and the accumulation of stock, trade increased not just the wealth but the 'productive powers' of all engaged in it. Each country should concentrate on producing those things in which it had a natural advantage. Smith argued that the state's duty was not to tax, direct or regulate commerce, but to guarantee the conditions of 'natural liberty' in which private commerce could prosper. Smith insisted that revenue should be raised only for the state's necessary functions — defence, law and order, and the provision of public goods needed to 'facilitate commerce in general'. The 'English ideology' was rounded off with the claim that free trade promoted peace, since it benefited all its participants.

In his *National System of Political Economy* (1844), the German economist Friedrich List argued that it was by protecting its 'infant industries' that England had gained the trading advantages which Smith called 'natural'. England now aimed to protect its industrial monopoly by preaching free trade to everyone else. List was the father of development economics. He proclaimed the state's duty to foster the growth of manufactures so that poor states could catch-up with rich ones. After 1879 tariffs started to rise all over Europe. The assertion of the state's right to tax the consumer for

the benefit of the producer marks the first point of re-entry for the 'Revenue Economy'.

The second re-entry point was socialism. In the *Communist Manifesto* (1848) Karl Marx claimed that capitalists robbed the workers by depriving them of the fruits of their labour. Democratic socialists rejected Marx's theory of capitalist crisis, but accepted his moral critique of capitalism. The historic task of socialism was to redistribute stolen surplus to the working class through progressive taxation. Here again the state was claiming the right to tax one section of the population for the benefit of another in order to secure a definite aim — in this case, 'social justice'. Redistribution was always an implicit, and often explicit, aim of the 'welfare states' created this century.

Economic nationalism was about growth, Marxism about redistribution. But both, by taking as their standing point an initial act of spoliation, and treating economic liberalism as an ideological device to maintain advantages unfairly gained, showed they were really in the business of redistributing wealth and power from the haves to the have-nots — whether the haves were states or classes. Twentieth century Marxism-Leninism would combine both approaches in an explosive mixture.

Expectation of war was the third, more traditional point of re-entry for the revenue economy, which had justified itself in the past by the protective function which the ruler rendered his subjects. The liberal dream that commerce would replace war faded in face of the spread of the 'new imperialism' in Africa and Asia at the end of the 19th century, the outgrowth of European power rivalries which followed German unification in 1871. The free trade doctrine was vulnerable to the argument that, in an uncertain world, states could not be indifferent to the global distribution of productive power, since this was bound to affect their capacity to wage war. Economic nationalists who argued for a protective tariff to shift productive power towards their country had the support of aristocratic rulers innocent of the doctrine of comparative advantage. Thus the ideal of cosmopolitan economy fell foul of the reality of national rivalry.

4. The era of classic collectivism: 1914-1945

In the first world war collectivist theory became collectivist practice. In political economy terms, this is the watershed of the 20th century, far more so than the second world war which produced a reaction against the collectivism of the 1930s. It is often argued that the demands of large-scale modern warfare required states to mobilise their societies for battle: a version of the technological determinist thesis. But this is to get it the

wrong way round. It was the awesome ability of modern governments to command the lives and resources of their subjects — product of their greatly enhanced political, organisational and calculating capacity — which enabled them to fight total wars: a triumph of means over ends. Periods of exhaustion which, in earlier times, would have produced an outbreak of peace, simply led to a tightening of the screw of state control. Significantly, the state least well-endowed in organisational capacity — the Russian empire — broke first.

Three crucial collectivist innovations are associated with the first world war: allocation of resources through state purchases and central planning; the inflation tax; and wage control through corporate arrangements. During the war, direct production orders were placed by the military sector; labour, raw materials, transport systems, and imports were requisitioned and allocated by new ministries of munitions and supply to secure their delivery. State factories were started to produce specialised equipment and synthetics. Subsidies were given to agriculture, and rationing became widespread. This was the start of central planning. Lenin remarked in 1917 that the 'material, economic half' of socialism had been realised in wartime Germany 'in the form of state monopoly capitalism'.⁵ Soviet Communism was inspired by the German war economy.

In the first world war, governments discovered (or rediscovered) the inflation tax. This is a device by which governments can transfer resources to themselves by printing money. When the extra money is spent, it raises prices: the government gets more of resources, the public less. After the initial period, this system of finance needs to be buttressed by control on wages and profits to ensure that the fall in the real value of private incomes is maintained. This standard account needs to be supplemented in one important respect. The idea of the government transferring resources to itself suggests that it uses them to pay for its staff. But for many purposes the state is merely a conduit for channelling resources to others. It may use the inflation tax to rob Peter in order to pay Paul. Thus the tax may serve the purposes of redistribution from rich to poor, from poor to rich, or from the private to the public sector, when a redistributory aim cannot be openly avowed. The crucial point is that public spending gives government a power of patronage. Spending financed by the inflation tax enables it to evade legal or democratic accountability for the way it spends the money.

Resort to inflationary finance in the first world war is explained by the fact that all the belligerents started war with a very narrow revenue base. Pre-war governments taxed and spent about 10 per cent of GNP. During the war governments ended up spending upward of 70 per cent of the national

income; 80 per cent of this spending was financed by printing money and borrowing — the state often borrowing back in war loans from the public the money it had just handed out to them. After the war, 'strong' states, like the USA and Britain, ended the inflation tax, and tried to restore at least some losses suffered by lenders and wage earners by reducing prices back to their pre-1914 levels, though in no case was this achieved. In the weak successor states of the defeated empires — Germany, Austria, and Russia — whose revenue bases had collapsed and which had lost all control over their wages funds, inflation spiralled upwards into hyperinflation and currency collapse.

The third legacy of the war economy was its method for conducting industrial relations. Governments used businessmen and trade union leaders as agents of wartime co-ordination and wage control and deliberately strengthened their organisations. This pointed to a 'cooperative' model of industrial relations, which broke with both the 'free market' of the Right and the class struggle of the Left. After the war the price mechanism was restored, but the strengthened business and labour organisations were left intact. Charles Maier has argued that the price of the 'bourgeois restoration' of the 1920s was a corporatist immobilism, which greatly hindered the adjustment of the European economies to changed conditions.⁶

The main ideological invention of the war was Marxism-Leninism. This was a mixture of classic Marxism and economic nationalism. Its bible was Lenin's *Imperialism*, written in 1916 to justify the project of a proletarian revolution in a largely peasant country. Lenin claimed that capitalism had been able to postpone its collapse in the industrial heartlands of Western Europe by bribing its workers with the 'super-profits' of imperialism. Revolution in the under-developed peripheries was thus the quickest way to bring world capitalism crashing down. The crucial invention here was the positing of a differential rate of exploitation for richer and poorer countries. Once Lenin seized power in Russia he took over the developmental ideology of the Tsars as filtered through Friedrich List: Communism was 'electrification plus the Soviets'.

Italian Fascism built onto the Leninist doctrine of the exploited or 'proletarian' nation the organisational innovations of the war in order to win Italy its 'rightful' place in the (imperialist) sun. The war had taught Mussolini four lessons: that nation is stronger than class, that the modern age is an age of struggle, that economic self-sufficiency is necessary for national security and that totalitarian control is feasible. It was the international, not class, struggle which was crucial. In industrial relations,

Fascism aimed to replace pluralist corporatism by state corporatism, or what the Nazis would later call *Gleichschaltung*. Fascism was the explicit progenitor of National Socialism in Germany, Francoism in Spain, and Peronism in Argentina; it was the unacknowledged inspiration of much of the theory of the 'developmental state', so influential in post second world war Latin America and post-colonial Africa. Its rhetorical advantage over Marxism-Leninism was that it left the system of private ownership intact, merely imposing state control over it. In terms of revenue control and planning this was a weakness.

The practice of the new dictatorships in the 1920s was less extreme than their rhetoric. The political economy of the 1920s was made of a number of half-way houses which can be schematised as follows:

- A. Conceptually the Communist state was the most radical. It took over the investment and wage-determination function from private owners, who were eliminated. In practice Lenin compromised, re-establishing rural capitalism in his New Economic Policy (1921).
- B. Italian Fascism left investment to the capitalists, but the state underwrote their control over the wages fund by breaking up the trade unions. Fascism's imperialist ambitions were in abeyance.
- C. In democratic capitalist countries, investment was in the hands of the capitalist owners, but control of wages was jointly shared between owners' organisations and trade unions (pluralist corporatism).

In all economies, taxation and public spending as a share of national income had more than doubled from prewar levels as the modern 'welfare state' established itself.

The 1930s saw a major peace time extension of the modern revenue economy. From the point of the Bolshevik leaders, the great flaw in Lenin's New Economic Policy was that it left about 50 per cent of the property and income of their subjects outside their direct control. This meant that the fund for 'primitive socialist accumulation' which was supposed to come from the kulaks, or rich peasants, was seriously depleted. Stalin's solution was to start the first Five Year Plan for forced industrialisation in 1929 which required the conscription of the whole of the property and savings of the countryside. In January 1930 he decreed the incorporation of all the peasant holding into giant food production 'factories' and the 'liquidation of the kulaks as a class'. What Stalin did was to seize the whole capital stock of the countryside. In the course of this seizure much of it was destroyed and agricultural production plummeted as millions of peasants

were murdered or died of starvation. (The same policy — with the same results — was repeated by Mao Tse Tung in his 'Great Leap Forward' in 1959-62). These 'successes' of Soviet planning, when contrasted with mass unemployment in the capitalist world, 'encouraged a growing belief [in the West] that no national economy could any longer be left at the mercy of the iron laws of the market. The Soviet five year plan ... seemed to provide a pioneering model'.⁷

At the same time, a section of the capitalist world reverted to aggressive imperialism. During the Great Depression (1929-32) the United States, Britain, France and the other leading colonial powers closed off their markets to foreigners. Italy, Germany, and Japan claimed that the breakdown of the welfare guarantee through the international division of labour forced them to become autarkic or self-sufficient. This made it necessary for them to acquire empires in order to secure access to raw materials and 'living space'. Germany and Japan turned fascist in the 1930s to acquire empires.

Although the capitalist democracies were influenced by autarkic ideas in the depth of the Depression they did not succumb to them. In fact economic liberalism was starting to revive before the second world war started in 1939. The key event was the conversion of the United States to free trade, after seventy years of high protectionism. Reversing the philosophy of the Hawley-Smoot tariff in 1930, the Reciprocal Trade Act of 1934 gave the President power to trade US concessions for tariff reductions abroad. In 1938, the Anglo-American Trade Agreement secured a partial dismantling of Britain's Imperial Preference system. By the Tripartite Agreement between the USA, Britain and France in 1936, all three powers agreed to support each others' currencies in the exchange market — though only for 24 hours! The critical intellectual event in 1936 was the publication of J.M. Keynes's *General Theory of Employment, Interest and Money*, showing how states could prevent or mitigate slumps. The three commitments to trade liberalisation, stable exchange rates and full employment were to be the basis of the reconstruction of the liberal economic order, when the Fascist alternative of the autarkic imperialism had been defeated in battle.

4. The mid-Century equipoise

For all the bad odour it has acquired Keynesian economics is perhaps the finest intellectual example of liberalism's ability to invent itself out of trouble — a quality notably lacking in its opponent doctrines, with the rhetorical exception of Leninism. The main message of the *General Theory*

is that full employment is a public good — it will be undersupplied if left to the market. Keynes wrote further that 'if nations can learn to provide themselves with full employment by their domestic policy ... there need be no important economic forces calculated to set the interest of one country against that of its neighbours'. Full employment was the condition of free trade and peace.

Keynes was never a collectivist in the sense I have been using the term — someone who wanted to replace private choice by government choice. He wanted to insert governments into the 'gaps' of a free economy — to do things which individuals wanted but in their private capacities could not achieve. Keynes played a key part in setting up the Bretton Woods system, designed to liberate trade from the tentacles which had strangled it in the 1930s. Between 1942 and 1944, Keynes, representing the British Treasury, and Harry Dexter White, the assistant secretary of the US Treasury, negotiated a set of institutions and rules designed to bring about a progressive liberalisation of trade and payments by insuring that a restored gold-exchange standard did not operate in a deflationary way. The Bretton Woods Agreement of 1944 set up an International Monetary Fund to supervise a system of fixed but adjustable exchange rates and to provide an adjustment facility, and an International Bank for Reconstruction and Development to provide economic help to developing countries. To these was added in 1947 a negotiating framework for freeing up trade — the General Agreement on Tariffs and Trade (GATT). Compared to the system which had grown up before 1914, much more explicit attention was given to the institutional foundations of a liberal international order.

The main political result of the second world war was the preeminent position occupied by the United States and the Soviet Union in the post-war order. This was to have an overwhelming influence, in practice, not just on the political economies of the two blocs they controlled, but on the development strategies of what soon came to be known as the 'third world'. The United States largely reshaped the political and economic arrangements of Germany and Japan, much to the benefit of its peoples, and via Marshall aid and the institutions for its disbursement (OEEC, WPU) promoted the 'common marketisation' of Western Europe. The Soviet Union instituted the modernised revenue economy in Eastern Europe, linked to its own central plan through COMECON. The Third World was the fluid frontier between the two systems. When China went communist in 1949 and India started its first five-year plan in 1950, it looked as though the whole of Asia, minus Japan and Taiwan, would succumb to collectivism. Autarkic, import-substituting industrialisation policies in Latin America survived from the wreckage of European Fascism.

The 1950s and 1960s were a golden age of all the systems of political economy, suggesting powerful secular forces making for growth, particularly widespread opportunities to introduce American mass production techniques, to contract low productivity agriculture, and to exploit cheap energy. This was the technological era when Galbraith's Detroit/Sverdlovsk comparison worked best. The rapid expansion in real incomes allowed improvements to be made in the social services without recourse to the inflation tax. Under Eisenhower, the United States, which set monetary conditions for the free world, followed a conservative financial policy and refrained from abusing its right of *seigneurage*.

However, despite the institutional recovery of the market, especially in trade and payments, substantial residues of collectivism survived from the 1930, even in the Western World. State spending after the second world war, at 30-35 per cent on average in OECD countries, was about ten per cent higher than in the 1920s. Post-war nationalisations in West European and developing countries had created a 'mixed economy', in which investment was shared by the private sector and the state. And the size of the wages fund was determined by corporatist bargaining between the big battalions on both sides of industry, more or less harmonious, depending on country. There was a modest tendency to wage inflation throughout the developed world in 1950s and early 1960s, with the more pronounced one in Latin America.

5. The return of the Revenue Economy

In the 1960s, this system of precarious, but fairly stable, balances was destroyed by its leading power, the United States. The proximate cause was the inflationary financing of the Vietnam war from 1966-9. Synchronised policy-induced booms in the early 1970s destroyed the Bretton Woods system of fixed exchanges in 1971 and triggered off a commodity price explosion which culminated in the quadrupling in the price of crude oil in 1973. A partly autonomous, partly induced, wage explosion added a further twist to the inflationary spiral. Between 1968 and 1973 a new phenomenon, 'stagflation' appeared in the West. For the OECD countries as a whole the 'misery index' (inflation plus unemployment) rose from 6.2 per cent in 1960-8 to 9.3 per cent in 1968-73 to 15.6 per cent in 1973-9. A crucial concurrent event in the Western world was the slowdown of productivity growth. The OECD rate of growth of real GDP per capita (a reasonable proxy for productivity growth) fell from 3.9 per cent a year in 1960-8 to 3.5 per cent in 1968-73 to 1.9 per cent in 1973-9. An important consequence of the growth slowdown was the 'fiscal crisis' of the state and

increasing resort to the inflation tax as welfare expenditures went on expanding while the growth of state revenue slowed down.

The deeper cause, and the meaning, of this disastrous sequence of events is to be found in the further inroads of the revenue economy on the market economy, justified in terms of growth and equality.

Growthmanship had its roots in three historically specific obsessions: the fear of the United States that it was losing ground to the Soviet Union; the fear of Britain that it was losing ground to the faster-growing Germans and French; and the failure of old-fashioned import substitution policies in Latin America to produce the expected 'catch-up' with the West. More generally, it was felt that the main sources of postwar market-led growth were drying up. Stagnation would endanger the legitimacy of 'welfare capitalism', which depended on annual additions to public spending. Higher spending on social services required continually expanding state revenue which, at given tax rates, required continuous growth if inflation was to be avoided.

Reinforcing, and interacting with, the dash for growth was the entitlements explosion. In the 1960s Western democracies became social democracies for the first time. In the United States this shift was manifested in the Kennedy-Johnson 'Great Society' programmes, fed by the civil rights movement, which aimed to integrate the blacks and other minorities into American life. Western European countries made new budgetary commitments in respect of education, training, health-care, pensions, etc. In Latin America the growing inequality produced by import-substitution growth strategies created a mass constituency for redistribution. The entitlements explosion may be seen as illustrating Wagner's law that as societies grow richer demands for social spending increase faster than incomes. The perceived need for faster growth to match the 'revolution of rising expectations' coalesced into a social democratic growth strategy based on expanding the public sector through deficit finance — simultaneously to raise growth and redistribute its fruits.

We now enter the era of pseudo-Keynesian finance. Its chief feature was fraudulent claims to calculating expertise, based on computerised forecasting, which enabled the revenue economy to reinvent itself as the uniquely rational actor in a world beset with market failure. (At exactly the same time the Soviets were hoping to 'perfect' their planning system by computerising it.)

The only new growth produced by growthmanship was growth in the size of the state. From the 1960s the share of public spending in national income

started to rise throughout the capitalist world. Total government outlays in the OECD countries, including transfer payments, rose from 36.7 per cent of GNP in 1960-8 to 41.2 per cent in 1968-73 to 48.5 per cent in 1973-9. With real per capita growth in the West slowing down rather than accelerating as it was meant to, governments increasingly resorted to the inflation tax to finance a level of public spending which now included compensatory outlays for rising numbers of unemployed. In order to keep resources flowing to the public sector, now the chief source of employment growth, governments resorted to 'incomes policies' — controls on wages backed, where necessary, by controls on prices and dividends. These marked a return to the statist corporatism first tried out in the first world war. In the 1970s a number of Western societies started drifting towards full-blooded collectivism not out of conviction, but because there seemed to other way to tackle the distortions and disincentives produced by the expanding revenue economy.

However, the move to full-blooded collectivism was checked, and eventually reversed, by lack of coercive power. In 1976 Professor Anthony King stated the problem as follows: 'the reach of British government exceeds its grasp, and its grasp is ... being enfeebled just at the moment when its reach is being extended'.⁸ The problem was even more obvious in developing countries, the economist Peter Bauer pointing out the absurdity of governments taking on ambitious development tasks, when they were unable to fulfil 'even the elementary and necessary functions of government'.⁹ The failure of Allende's experiment in Chile in 1974 was a crucial setback for collectivism in Latin America. The drift to ungovernability in the capitalist world was matched by the weakening grasp of the Communist leadership over the central planning system.

Given the lack of coercive power, there was only one possible outcome: the withdrawal of governments from exposed positions. At the end of the 1970s governments in practically all OECD countries took the critical decision to liquidate inflation and reduce budget deficits. This implied abandonment of full employment policy. In face of the second oil prices rise in 1979-80, 'strong' states (the United States, Britain, Germany), backed by popular mandates, tightened fiscal and monetary policy, bringing about the worst slump since the 1930s. 'Weak' states went on inflating. Developing countries, which had maintained their public investment booms throughout the 1970s by borrowing recycled petrodollars at negative real interest rates, found themselves faced with crippling debt burdens as export earnings collapsed, real interest rates rose to punitive levels, and foreign investment dried up. The financial institutions stepped in, imposing tough stabilisation policies. Soviet satellites like Poland, Romania and Hungary

which had also borrowed heavily from the West in the 1970s in a vain effort to develop hard currency exports also found themselves hit by debt. In 1978, the Chinese leader Deng Tsiao-Ping, in a decisive reform, restored rural capitalism in China. Beset by the same problem of loosening grasp, the new Soviet leader Andropov embarked on the opposite track of trying to restore labour discipline through increased coercion.

What turned these stabilisation efforts of the early 1980s into a world-wide assault on the revenue economy was the realisation that macroeconomic imbalances had their source in the over-extension of the state. The measure of this over-extension was the growing gap between state revenues and state expenditures. The only way of closing this gap seemed to be to reduce the role of the state — getting it out of things it should not be doing and could not do well. The rebalancing of the market and revenue economy would allow faster growth which would give the state adequate resources to provide the public goods it needed to.

6. State damage and state repair

The tremendous increase in the political, administrative and organisational capacity of the modern state has tempted it to promise and do too much: more than it could achieve and more than the conditions of consent allowed, except for brief periods. As the performance of states fell increasingly below expectation, so the resistance to their pretensions grew, forcing a retreat from collectivism back to market economy. This is the meaning of the transition through which we are now living.

The collapse of the state was most total where its pretensions were greatest. Like all empires, the Soviet Empire was based on coercion, and broke up when it lost the will and means to coerce its subjects. However, while the collapse of the colonial empires of this century left their economic systems intact, the collapse of Soviet rule brought down the Soviet economy too. This was because Soviet Communism was a system of economic as well as political monopoly. The Soviet economy could not function where it not centrally commanded, for it existed to fulfil a central plan, not to satisfy market demands. When Communist Party rule collapsed, the central planning system collapsed. When the central planning system collapsed, the economy collapsed. There was no one to tell it what to do.

The proximate cause of the Soviet empire's collapse was state bankruptcy. This is the common cause of breakdown of all rule from the Roman Empire to our day. The economy declines while the state's need for revenue expands. The Soviet economy was based on 'extensive' production, and started to decay when it ran out of free, or cheap, resources of land and

labour. The Soviet state lost to its territorial magnates and enterprise directors its ability to appropriate a declining surplus. At the same time, the pressure on its social and military budget rose to provide growing subsidies to loss-making industries and to counter Reagan's arms build-up in the 1980s. Like the Roman Empire, the Soviet empire split into a large number of successor states when its central government ran out of money.

Capitalism survived, when communism failed, because, faced with similar, though far less acute problems, it was able to invent itself out of trouble. It produced powerful political entrepreneurs like Margaret Thatcher and Ronald Reagan who sensed the public appetite for a reduced state. But the new ideology was also highly sensitive to the fact that the kind of national control over economies attempted by governments in the 1960s and 1970s had been rendered obsolete by technological changes. Put simply, what was to be controlled had become increasingly invisible, disaggregated or beyond the reach of national governments. This thesis was strikingly proclaimed by David Howell in 1984:

Big solid sectors, classes and Blue Book categories, the chunky raw material of the centralists, the state socialists, as well as the Keynesian demand managers, are melting, mingling and dissolving. The 'soft' economy, in which more and more people are engaged in knowledge-based industries and services, and in which physical manufacturing employs fewer and is less concentrated, has started to assume new characteristics which baffle economic planners. We seem to have entered an era in which economic cycles move in smaller waves and in which a new climate of stability, without central intervention, may be attainable. In this sense, therefore, the anti-collectivists and the anti-statists have won hands down ... The corporatists, who rested their thinking on big unionism, big government, big finance and a big industry are seeing their edifice collapse ... The computer and micro-electronic communications disperse power and knowledge, and therefore traditional political formations, just as they disperse and alter industrial and commercial activity.¹⁰

Howell was pointing to the collapse of what Marxists called 'Fordism' — a system of large-scale factory, conveyor-belt production geared to economies of scale, and based on steel and abundant supplies of cheap energy and, initially, cheap labour. The essential point is that the new computer and information based technology has decreased the importance of economies of scale, bringing the benefits of specialisation within reach of specialists as well as mass producers. Just as the old technology favoured a hierarchic, statist, corporatist world, so the new technology ushers in a new wave of market liberalism. Crucially, by favouring small business, it has seriously undermined corporatist wage-setting based on the assumption of centralised business and union bargainers.

The historically minded will see in this process a repetition of the forces which broke up the great mercantilist empires of the eighteenth century, ushering in the free trade age. With the reduction in transport costs, the great chartered companies could no longer keep out 'interlopers'. But the case for technological determinism is not established by this or by later episodes. Recent events are more plausibly explained by a Toynbeeian 'challenge and response' mechanism. The microchip was capitalism's spontaneous response to soaring energy prices, labour militancy and collapsing profitability. An important consequence of cost-cutting through computerisation has been the falling price of unskilled labour which, when resisted, led to the emergence of heavy unemployment in the 1980s.

If the problem for the post-communist countries is to reconstitute a viable state, the problem for the capitalist democracies is in a sense the opposite: to continue the work of dismantling the revenue state. The general tendency is clear. With extensive privatisation the state has been dislodged from its role as accumulator, or investor. The corporatist arrangements whereby the state, big business and trade unions tried to control the wages fund has been, or is being replaced, by private owner-determined contracts, increasingly on an individual basis. However, the state as redistributor and welfare provider is still very much in business. Indeed its business has increased with heavy persisting unemployment and the growth of an underclass. In the European OECD countries total outlays of general government as a ratio of GDP were 45.9 per cent in 1979 and 54.6 per cent in 1993; total receipts were 41.9 per cent in 1979 and 48.1 per cent in 1993. Since 1979 OECD governments have increased their spending, and they have managed to enlarge their receipts by switching to less visible forms of indirect taxation. With economic recovery from the recent slump the gap will close — but a situation in which budgets return to balance with the state spending 50 per cent or so of the national income is hardly one which exhibits a dramatic retreat of the revenue economy. In addition, the West European ratio of state spending to GDP is much higher than that of the more dynamic East Asian economies which, for all their state intervention in export promotion, have never been revenue economies in the European sense.

It is ironic that leaders of the newly marketised East European economies should be preaching market reforms to Western Europe. Thus Vaclav Klaus, prime minister of the Czech Republic:

The available evidence suggests that Western Europe does not provide an optimum model for balancing freedom with regulation. The system ... is too weighted down with over-regulation and over-control. The welfare state with its general transfer payments unconnected to achievement undermines the basic

work-ethic and thus individual responsibility. There is too much protectionism. There is too much bureaucracy ... The Thatcherite revolution stopped at best half way in Western Europe ... Various Western European countries have pushed budget deficits to the limit. Budget deficits ... are a product of the logic and structure of the European welfare state, not of any accidental fiscal mismanagement. They reflect the misplaced emphasis on redistributive (instead of productive) processes, favoured by a significant proportion of European politicians and their constituents. Spending rises inexorably; taxes cannot be increased any further ...¹¹

These problems of Western economies affect the speed, even the possibility, of reintegrating the post-communist societies into the European mainstream. A major obstacle to free trade is persisting heavy unemployment, particularly in Western Europe. This encourages protectionism, currently operated through environmental and anti-dumping rules. So Western European governments need to reduce taxes and other obligations on employers, which turn out to be taxes on employment. But, however flexible labour markets are they cannot guarantee full employment against the danger of periodic economic collapse. So the state still has a stabilising role. But it cannot play such a role and at the same time run a welfare state whose costs exceed the willingness of taxpayers to pay for it. So a financial rule which excludes inflation while allowing the state to provide the public good of economic stability has to be reinforced by an anti-collectivist rule which limits the share of state spending in GDP to an amount which does not cause financing problems. A world in which money incomes are stable will be favourable to greater stability of exchange rates. This would enable the restoration of part of the Bretton Woods system missing since the collapse of Smithsonian parities in 1973.

It is often alleged of historians that the only future they can imagine is the past, and it is true that I am arguing for a reconstruction of the framework conditions of the 'golden age' of 1950s and 1960s for a new global economy as the best assurance against the revival of the collectivist economy. It seems to me that this framework for a liberal order, worked out in reaction to the rampant collectivism of the 1930s, still offers the best available balance between freedom and security, individual responsibility and state regulation, market and revenue economy. But I am not calling for a mindless restoration. What we have learnt since the 1960s is that rules are needed to limit the *hubris* of governments which has been the royal road back to the revenue economy — in particular, a financial rule limiting recourse to deficit finance and an anti-collectivist rule limiting redistributive taxation. In short, the framework of the 'golden age' needs to be buttressed by a 'constitution of liberty'. The construction of such a

constitution can only gain by reflecting on the historical experience of our century, from all its vantage points.

Notes and References

- ¹ Francis Fukuyama, *The End of History and the Last Man*, 1992.
- ² Mancur Olson, *The Rise and Decline of Nations*, 1982, p.254, n.22
- ³ Sir John Hicks, *A Theory of Economic History*, 1969, pp.22-4
- ⁴ See J.K.Galbraith, *The New Industrial State*, 1967
- ⁵ Q. E.H. Carr, *The Russian Revolution from Lenin to Stalin 1917-1929*, p186
- ⁶ Charles Maier, *Recasting Bourgeois Europe*, 1975
- ⁷ E.H.Carr, *op.cit.*, p.152
- ⁸ Anthony King, *Why is Britain becoming Harder to Govern*, 1976, pp.15-16
- ⁹ Q. in *The World Bank Development Report*, 1991, p.34
- ¹⁰ David Howell, *Blind Victory: A Study in Income, Wealth and Power*, 1984, p.4
- ¹¹ Vaclav Klaus, *The Economist*, 10 September 1994

PAPERS IN PRINT

Price

1	<i>The Social Market Economy</i> Robert Skidelsky	£3.50
2	<i>Responses to Robert Skidelsky on The Social Market Economy</i> Sarah Benton, Kurt Biedenkopf, Frank Field Danny Finkelstein, Francis Hawkings, Graham Mather	£3.50
3	<i>Europe Without Currency Barriers</i> Samuel Brittan, Michael Artis	£5.00
4	<i>Greening The White Paper: A Strategy for NHS Reform</i> Gwyn Bevan, Marshall Marinker	£5.00
5	<i>Education and the Labour Market: An English Disaster</i> Adrian Wooldridge	£5.00
6	<i>Crisis in Eastern Europe: Roots and Prospects</i> Robin Okey	£4.00
7	<i>Fighting Fiscal Privilege: Towards a Fiscal Constitution</i> Deepak Lal	£4.00
8	<i>Eastern Europe in Transition</i> Clive Crook, Daniel Franklin	£5.00
9	<i>The Open Network and its Enemies: Towards a Contestable Telecommunications Market</i> Danny Finkelstein, Craig Arnall	£5.00
10	<i>A Restatement of Economic Liberalism</i> Samuel Brittan	£5.00
11	<i>Standards in Schools: Assessment, Accountability and the Purposes of Education</i> John Marks	£6.00
12	<i>Deeper Share Ownership</i> Matthew Gaved, Anthony Goodman	£6.00
13	<i>Fighting Leviathan: Building Social Markets that Work</i> Howard Davies	£6.00
14	<i>The Age of Entitlement</i> David Willetts	£6.00
15	<i>Schools and the State</i> Evan Davis	£6.00

16	<i>Public Sector Pay: In Search of Sanity</i> Ron Beadle	£8.00
17	<i>Beyond Next Steps: a civil service for the 1990s</i> Sir Peter Kemp	£8.00
18	<i>Post-Communist Societies in Transition: A Social Market Perspective</i> John Gray	£8.00
19	<i>Two Cheers for the Institutions</i> Stanley Wright	£10.00
20	<i>Civic Conservatism</i> David Willetts	£10.00
21	<i>The Undoing of Conservatism</i> John Gray	£10.00
22	<i>Meritocracy and the 'Classless Society'</i> Adrian Wooldridge	£12.00
23	<i>Public Spending into the Millennium</i> Nick Bosanquet	£10.00

REPORTS

1	<i>Environment, Economics and Development after the 'Earth Summit'</i> Andrew Cooper	£3.00
2	<i>Another Great Depression? Historical lessons for the 1990s</i> Robert Skidelsky, Liam Halligan	£5.00
3	<i>Exiting the Underclass: Policy towards America's urban poor</i> Andrew Cooper, Catherine Moylan	£5.00
4	<i>Britain's Borrowing Problem</i> Bill Robinson	£5.00

OCCASIONAL PAPERS

1	<i>Deregulation</i> David Willetts	£3.00
2	<i>'There is no such thing as society'</i> Samuel Brittan	£3.00
3	<i>The Opportunities for Private Funding in the NHS</i> David Willetts	£3.00

148

4	<i>A Social Market for Training</i> Howard Davies	£3.00
5	<i>Beyond Unemployment</i> Robert Skidelsky, Liam Halligan	£6.00
6	<i>Brighter Schools</i> Michael Fallon	£6.00
7	<i>Understanding 'Shock Therapy'</i> Jeffrey Sachs	£8.00
8	<i>Recruiting to the Little Platoons</i> William Waldegrave	£6.00
9	<i>The Culture of Anxiety: The Middle Class in Crisis</i> Matthew Symonds	£8.00
10	<i>What is left of Keynes?</i> Samuel Brittan, Meghnad Desai, Deepak Lal Robert Skidelsky, Tom Wilson	£8.00
11	<i>Winning the Welfare Debate</i> Peter Lilley, (Introduction by Frank Field)	£10.00

OTHER PAPERS

	<i>Local Government and the Social Market</i> George Jones	£3.00
	<i>Full Employment without Inflation</i> James Meade	£6.00

MEMORANDA

1	<i>Provider Choice: 'Opting In' through the Private Finance Initiative</i> Michael Fallon	£5.00
2	<i>The Importance of Resource Accounting</i> Evan Davis	£3.50
3	<i>Why there is no time to teach: What is wrong with the National Curriculum 10 Level Scale</i> John Marks	£5.00
4	<i>All free health care must be effective</i> Brendan Devlin, Gwyn Bevan	£5.00
5	<i>Recruiting to the Little Platoons</i> William Waldegrave	£5.00

6	<i>Labour and the Public Services</i> John Willman	£8.00
7	<i>Organising Cost Effective Access to Justice</i> Gwyn Bevan, Tony Holland and Michael Partington	£5.00
8	<i>A Memo to Modernisers</i> Ron Beadle, Andrew Cooper, Evan Davis, Alex de Mont Stephen Pollard, David Sainsbury, John Willman	£8.00
9	<i>Conservatives in Opposition: Republicans in the US</i> Daniel Finkelstein	£5.00
10	<i>Housing Benefit; Incentives for Reform</i> Greg Clark	£8.00
11	<i>The Market and Clause IV</i> Stephen Pollard	£5.00
12	<i>Yeltsin's Choice: Background to the Chechnya Crisis</i> Vladimir Mau	£8.00
13	<i>Teachers Practices: A New Model for State Schools</i> Tony Meredith	£8.00
14	<i>The Right to Earn: Learning to Live with Top People's Pay</i> Ron Beadle	£8.00
15	<i>A Memo to Modernisers II</i> John Abbott, Peter Boone, Tom Chandos, Evan Davis, Alex de Mont Ian Pearson MP, Stephen Pollard, Katharine Raymond, John Spiers	£8.00
16	<i>Schools, Selection and the Left</i> Stephen Pollard	£8.00
17	<i>The Future of Long-Term Care</i> Andrew Cooper & Roderick Nye	£8.00

HARD DATA

1	<i>The Rountree Inquiry and 'Trickle Down'</i> Andrew Cooper, Roderick Nye	£5.00
2	<i>Costing the Public Policy Agenda: A week of the Today Programme</i> Andrew Cooper	£5.00
3	<i>Universal Nursery Education & Playgroups</i> Andrew Cooper, Roderick Nye	£5.00
4	<i>Social Security Costs of the Social Chapter</i> Andrew Cooper, Marc Shaw	£5.00
5	<i>What Price a Life?</i> Andrew Cooper & Roderick Nye	£5.00

150

Russia's Stormy Path to Reform is a fascinating report of a high-level seminar held in Moscow between leading Russian, American and British thinkers and politicians to discuss the hopes, aims, constraints and possible outcomes of the reform process in the Russian Federation. The ground they cover is as broad as it is revealing:

- ◆ inflation rates of up to 18% a month, and annual interest rates ranging from 160% to 190%;
- ◆ the growth of a new and vibrant mafia out of the old nomenklatura;
- ◆ the suppression of the rising in Chechnya viewed as 'a necessary national economic policy'.

These predicaments and their harsh solutions may surprise, and sometimes shock, the casual observer but they also drive to the heart of political economy and the nature of the state. As Robert Skidelsky points out, the 'revenue state' required to finance the ambitions of an overbearing ruler or ruling clique has featured in even 'mature democracies' for most of this Century.

The study of transition economies is not, therefore, an exercise in political anthropology. It is also an opportunity for us to view our own institutional and economic arrangements. For this reason *Russia's Stormy Path to Reform* deserves to be read by a far wider audience than the Kremlin-watchers and the devotees of the 'Common European Home'.



CTE Paper No. 1

ISBN 1 874097 85 2
© The Social Market Foundation

£20.00