

# Ignore Sovietology at Your Peril

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The year 1997 not only marks the fifth anniversary of the publication of *Demokratizatsiya* but also the fifth anniversary of Yeltsin's economic reforms. Shock therapy, as it was often called, was designed in part with advice from several Western economic theorists who specialized in economic development and transformation. Given their earlier successes with other developmental efforts as well as their own acknowledged ability, many of these specialists were regarded as among the best and the brightest in the Western economic profession. However, few if any of them had much exposure to what was then regarded as sovietology. But given the success of earlier transformation efforts in other parts of the world and their belief that economics, not culture or history, is the most important factor in economic development, many of those involved in Russia wrote off warnings from sovietologists about the uniqueness of the Soviet Union as special pleading and even overzealous protection of intellectual turf.

It may be slightly premature but now that the reforms are almost six years old, it behooves us to look at the record and evaluate what has happened. Since 1992, we have been told annually that the bottom has finally been reached and that next year gross domestic product will increase. Admittedly, Russian statisticians have had trouble reflecting what has been happening in the private and underground sectors of Russia. Moreover, visitors to Moscow are stunned by the physical changes that have taken place. There is no doubt that important and positive structural changes have occurred. Yet the official figures, which at least seem to encompass much of the old heavy industrial sector, do show a continuing decline, at least through 1996. In the extreme case, there are indicators that show that the 1996 GDP was barely half of that which was reported in 1996. In fact, officially at least, industrial production and GDP declined more in 1996 than they had in 1995. Moreover, the reforms have left in their wake an unprecedented degree of corruption, distorted privatization, and crime that will not be easily remedied. To the extent that such reports approximate the actual situation, those who so confidently predicted their reform efforts would bear early fruit should go back to ascertain where they went wrong.

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Nonsovietologist economists began to concern themselves with the Soviet economy only after Gorbachev began to allow for the possibility of a basic structural reform. Prior to that, the theoretical challenges arising from a study of the Soviet economy were usually thought of as being relatively trivial and therefore not worth the time needed to study the culture or language. When Gorbachev signaled that the Soviet economy would be restructured along Western lines, the possibility was raised of an entirely new approach and even a new school of thought: transition economics. Because it seemed so unlikely, few had spent much time examining how a planned economy in a Communist country should go about transforming itself into a market economy. (Egon Neuberger was one of the few who did.) However, when the Soviet Union or the other East European economies began to think market, then the Western economists began to assume that the relevant issues would be little different from those being debated by mainstream economists around the world. And just as the American economists felt comfortable analyzing macro- or microproblems in Nigeria, Australia, or Bolivia without the need to learn about their respective cultures, history, or local dialects, so these Western economists saw nothing wrong with prescribing cures for the Soviet Union. Also, as the Soviet Union began to open to the outside world, more and more of its problems began to resemble those of any other developing country.

Many of those newly involved in looking for ways to help the Soviet Union evolve successfully were sometimes influenced by other, more parochial concerns. In part, that may explain why some of those advocating support for massive foreign aid programs such as the Grand Bargain seemed hesitant about involving traditional sovietologists in their effort. As they saw it, many of the established Soviet specialists were too downbeat about the Soviet Union, if not anti-Soviet. Who would be willing to put up billions of dollars a year if those arguing for such aid efforts were so negative about the prospects? It seemed better to bring in a whole new crew, unsullied by past slights or vendettas. After all, Russia seemed to be embarking on a new course toward a new world with new moralities, new aspirations, and new codes of behavior. Why waste time reliving the battles of the past? In much the same way, MacDonald's in Moscow insists that because it so difficult to unlearn old patterns of behavior, they will never hire anyone who previously has worked in a Russian restaurant.

Those who subsequently became involved in advising reformers about designing the reform effort reacted to consulting sovietologists in much the same way. To mainstream Western economists, sovietologists seemed to be little more than special pleaders. To the pure economists, market reform was a relatively simple matter. When market mechanisms were unshackled, Russians would respond the same as their counterparts all over the world. There was, these economists insisted, no such thing as a unique Soviet economic man (*Homo Sovieticus*); there were only universal economic men. When faced with higher prices, Soviet decision-makers, just as Brazilian decisionmakers, will reduce their consumption and increase their output.

Much the same thinking shaped their attitudes toward the privatization of Russian industry. Some of the more ideologically committed felt a particular

urgency. As they saw it, it was essential that privatization be implemented as quickly as possible because only then would the universal economic man emerge in Russia. As long as state ownership was the dominant form of control, factory directors in Russia would do little to shake themselves loose from complete dependence on government ministries and continuing subsidies. Hard budget discipline (no subsidies to unprofitable firms) was not a realistic option in a state-dominated economy.

For true believers such as Boycko, Shleifer, and Vishny, private ownership was superior to state ownership and control, even if the new owners happen to be members of or under the control of the mafia. That does not mean that they welcomed criminal involvement in the privatization process—far from it. But in their eyes, if by chance the mafia did seize control of a business, this was likely to be only a passing episode. Market forces would ultimately set in motion their own self-correcting mechanisms. According to this reasoning, if the managers proved to be incompetent, they would ultimately be replaced by more competent managers; to protect their investments, the owners would insist on it. And if the owners failed to act, sooner or later the enterprise would go bankrupt or at the least the owners would begin to divert their funds to investments with a higher yield. With private ownership, the flushing-out of the mafia or otherwise incompetent managers might not take place overnight, but the pressures for higher-yielding investments are irresistible, and a Russian investor, a member of the mafia or not, will react in the same way as a Western investor, particularly if they see that managers elsewhere are generating a higher rate of return: thus the arguments that the Russian economic man is no different from the universal economic man. By contrast, if the government is the owner, only under the most unusual circumstances would there be any pressure to force out existing managers. In other words, while private ownership might mean there would be moments when profit maximization might not be the prime determinant, with state ownership the failure to search for profit maximization might be a permanent situation.

In most countries of the world, arguments of this sort make perfect sense. It is easy to see why supporters of a *laissez faire* and those upholding the University of Chicago approach to private enterprise and markets reason the way they do. What they fail to appreciate, however, is that such behavior makes sense only if the proper infrastructure is in place, as it is in most other parts of the world.

In the example of the incompetent mafia boss, there will be pressures to remove him only if by comparison there is an opportunity cost; in other words, that there are other businesses or investment opportunities that offer a higher return. This, in turn, presumes a competitive environment where merit makes a difference. It also assumes not only the existence but also the operational effectiveness of a set of essential market institutions, including impartial courts and judges, commercial codes, security regulations, and effective law enforcement.

While they normally disagree about a whole range of issues, Western sovietologists agree that one of the distinguishing characteristics of the region they study is the absence of those very institutions that are the essence of a market environment. Much of this is attributable to the seventy years of communism and

the effort after 1928 to stamp out the vestiges of the market system. Anyone engaged in private business activity, if caught, might very well have been charged with “an economic crime.” In Nikita Khrushchev’s time, that meant death. Even earlier, Stalin destroyed millions of the middle-class farmers and outlawed private farming other than small gardens. Of course, Lenin and Stalin also nationalized all industrial and commercial activities and abolished all commercial codes, competitive practices, and private capital markets.

Moreover, while most of the repression of market access was a centerpiece of the Communist era, many of these antibusiness attitudes predate communism. The tsarist era also can be characterized, for example, as less than market friendly. It was rigidly regulated, and if a businessman wanted to incorporate, special permission of the tsarist government was required. Registration was not given automatically or routinely. This guaranteed widespread corruption and market imperfection. Nor did it help that the peasants were classed as serfs until 1861; even after emancipation they were more or less confined to the *obshchina* or commune, and until about 1907 the land they tilled was periodically redistributed. This was done intentionally to discourage inequality and to prevent too deep an attachment to the ownership of a particular piece of land.

Anyone designing a reform program dealing with the market or property rights in Russia must allow for the fact that the Russian reaction may be different from that of someone brought up in a market environment. The Russians acknowledge their differences by laughing at themselves. They tell the story of the genie who offered to fulfill the wishes of the first three people she met. She first asked a Frenchman what he would like. “Oh, I’d like a chateau, a vineyard, and a mistress.” Next she asked an American. “Well, I want a laptop computer, a VCR, and a handgun.” Finally she encountered a Russian. After a long pause the Russian finally concluded, “My neighbor has a goat, I don’t have a goat; kill my neighbor’s goat.”

In addition to these differences in attitude and the elimination of virtually all institutions associated with a competitive market system, the Soviets also purposely designed institutions that, intentionally or not, served to frustrate any efforts to reinstitute a market system. In a sense, they booby-trapped the system. For example, because many Soviet leaders were trained as engineers, there was wide acceptance of the notion of economies of scale. To make this possible, a central planner had to restrict the number of operating production sites. Inevitably, this also served to limit competition. Thus, Soviet industrial enterprises tended to be very large and monopolistic. While monopolies are viewed with disquiet in a market system, if anything they were a source of pride in the USSR, even if this gigantomania, as they called it, sometimes resulted in wasteful distortions.

Anyone attempting to transform the centrally planned Soviet economy into a market-oriented enterprise system without allowing for such differences in cultural behavior and institutional environment was all but guaranteed a grossly distorted result. The best analogy is what often happens when an alien species is transplanted to a different ecological system. For example, an effort was made at

the beginning of the twentieth century in the Florida Everglades to ameliorate some of the swampland. To supplement the drainage effort, officials decided to import an Australian tree called the melaleuca because it had proved to be so effective in controlling erosion. What these officials neglected to consider, however, was what would happen when an alien organism was transplanted to a different ecological system without the built-in predators and checks and balances that control that organism in its original environment. Without such self-governing controls, melaleuca forests have gobbled up 1.5 million acres of the Everglades' 6.5 million acres and now are spreading at the rate of 50 acres a day. As a report in the *New York Times* put it, "The melaleuca has become an environmental threat that chokes other plant life," and it "changes the habitat for everything—the water flow is disrupted and the diversity of plants falls to almost zero." Ordinary controls, such as fire, mechanical cutting, and even herbicides, have proven to be ineffective. As a result, the Department of Agriculture finally decided to go back to Australia and see how the melaleuca was controlled in its original ecosystem. As an experiment, they decided to import a snout beetle that eats only melaleuca leaves and flower buds. This is a classic study of what can happen when foreign organisms are introduced into an alien environment.

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What happened in 1992 in Russia bears a strong resemblance. The shock therapy reforms were also an attempt to change a system and replace it with an alien organism, but in this case it was not a biological but an economic political system. As we have seen, competition was virtually nonexistent. Nor were there regulations dealing with corporate securities, shareholder rights, bankruptcy, antitrust, commercial bank regulations, and private land ownership. Moreover, because the court system was a legacy of the Communist era, virtually none of the judges had any experience dealing with private business. For that matter, most of the judges were appointed because they were good Communists. As for the state enterprises, most of them were monopolies, and because little was done to facilitate the formation of new business, there were virtually no checks and balances on the behavior of those monopolists.

Like the introduction of the melaleuca trees in the Everglades unaccompanied by their natural predators, so the privatization of state-enterprise monopolies and the absence of a set of institutional predators was all but sure to disrupt the Russian economic system. This is where the arguments of the economists and their universal economic man break down. For example, the insistence that the mafia type or incompetent managers will soon be swept away is all well and good as long as there is an established and effective court system, as well as stockholder

rights and a relatively honest government. In such an environment, ineffective managers will indeed be fired. But in Russia, where the governing morality for decades was that it was acceptable to cheat the state, without the necessary institutional safeguards, as often as not the mafia manager makes up for his business incompetence with his muscle or strong-arm skills. If a more effective competitor appears, rather than produce a new and better product or design a new marketing strategy to compete, the simplest approach is to intimidate or destroy potential competitors. And if on occasion a competitor does not succumb to such pressures, even then it is likely an incompetent manager will not be forced out because without bankruptcy laws, there is little need to pay wages or bills. And because government officials have such easy virtues, very few of the newly privatized enterprises have had to worry much about paying their taxes.

The results are similarly disappointing when it comes to mounting proxy fights. While new laws are being proposed, heretofore the minority stockholder usually has very little protection. All too often stockholders find the existing management disregards their inquiries and their votes. Until recently, even a group of stockholders holding 40 percent of the stock in the Novolipetsk Metallurgical Combine found that its managers refused to give them any voice on the board of directors. In other cases, the registry page listing of stockholder purchases in the enterprise simply disappeared. Or at Gazprom, until mid-1997 its officers reserved the right to deny the purchase of stock to investors of whom they disapproved. At the same time, it is relatively common among enterprise directors that whenever it looks like an outside investor may be about to obtain majority control, the simplest solution is to issue more shares of stock secretly to the existing insiders to ensure their continued dominance. That is one of the reasons that as few as 10 percent of the enterprise managers who were in command at the time of privatization have been replaced.

In pushing forward with their economic reforms, those who persisted in ignoring Russian culture and history gave birth to a monster. Without a system of checks and balances and institutional predators, the now private monopolists have effectively managed to choke off most competition and guarantee themselves controls that reach to the government itself. The mafia world has spread in the same way. Moreover, once established in power, these institutional aberrations have become very difficult to uproot.

It must be acknowledged, nevertheless, that beginning in March 1997 a new team of reformers has sought to remedy some of the more blatant distortions. Led by Boris Nemtsov, the recently appointed first deputy prime minister, the government is now seeking to collect taxes from some of the biggest tax scofflaws, including the mother of all monopolies, Gazprom. Similarly, Nemtsov is seeking to force commercial banks to compete for government deposits and require that businesses submit tenders for contracts. Yet, Boris Nemtsov is one man, and until he came along no one else seemed to care or have the ability to do anything about the crying need for such efforts. But even Nemtsov is mortal, and the reforms he needs to make are so extreme that bettors are already offering odds as to how long Nemtsov will last before his enemies destroy him and his reputation. And because

control of state assets is potentially so lucrative, it is hard to see how Nemtsov, particularly as he begins to step on an increasingly large number of vested interest feet, can survive Kremlin skullduggery. Yet there are a few of us who feel that Nemtsov, despite the odds, will outmaneuver his opponents and put in place the institutional surgery that the reformers concerned only about economics mistakenly took for granted.

All of this is not to insist that if sovietologists had been put in charge of the reform effort or privatization that those efforts would have been a success. Given the magnitude of what was being attempted, any effort, including those with sovietologist advisors, would likely have encountered difficulties. However, if the country's reformers and their advisors had acknowledged that Russia was, after all, different, distortions stemming from the reforms might have been fewer and less permanent in nature.