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Karen LaFollette

Karen LaFollette is a research associate with the Institute for Political Economy in Washington, D.C., and coauthor of *Meltdown: Inside the Soviet Economy.*

Executive Summary

The world seems awash in mismanaged, unpayable government debts. At the International Monetary Fund and World Bank, officials are working to reschedule some $6 billion in delinquent loans by rolling them over into new and larger loans. The Bush administration is proceeding with efforts to forgive debts owed the U.S. government by the governments of Poland, sub-Saharan African nations, and our Latin American neighbors. Many of those debts are to the U.S. Export-Import Bank. Nearly $5 billion (or 48 percent) of outstanding Ex-Im Bank loans are delinquent or have been rescheduled, and losses totaled $2.3 billion between 1982 and 1988. And under the Brady Plan (named after U.S. Treasury secretary Nicholas Brady), many of those same governments have received, or are seeking, forgiveness of the debts they incurred to private banks.

What is the lesson here? Government-to-government loans, as well as private bank loans to governments, are managed by bureaucrats whose own money is not at stake and who necessarily make investment decisions according to political criteria. Thus, valuable resources are used to a variety of unproductive ends. For all the rhetoric about the need for further economic progress, the unprecedented levels of public and private loans to developing-country governments throughout the 1970s and 1980s promoted or led to graft, expansionist bureaucracies that frustrate private-sector activity, and debts that cannot be repaid.

Roundly ignoring that lesson, the Bush administration and other Western governments have been promoting debt-financed development, through government-to-government loans, for the Soviet Union. In September 1990 the Soviet central government sent observers to the IMF and World Bank annual meetings in Washington, D.C., and later indicated that it intended to seek membership in the two institutions. When President Bush, on December 12, proposed granting the Soviet Union "associate" status, which would entitle it to economic advice and technical assistance from the IMF and World Bank, it appeared that full membership and borrowing privileges would be only a matter of time. Indeed, on December 26 the Soviet news agency Tass reported that the Soviet Union was negotiating a time frame for entry into the World Bank and IMF.[1]

In January 1991 Moscow's crackdown on the secessionist governments of Lithuania and Latvia led the United States and other major industrial (Group of Seven) nations to put on indefinite hold all plans for IMF and World Bank assistance to the Soviet Union. Nonetheless, the U.S. and other G-7 governments themselves continue to disburse unprecedented levels of government loans and loan guarantees to the Soviet regime of Mikhail Gorbachev. The aid presently flowing is directly underwriting the Soviet central government's political and economic repression. In turn, if and when the political upheaval in the Soviet Union settles, the United States and other G-7 nations will most likely resume their efforts to place the Soviet economy under the tutelage and patronage of the IMF and World Bank. That

will only prolong government retrenchment in the Soviet Union and "hook" the central government, or the governments of the republics, on the same kinds of subsidized loans that have financed big government throughout the developing world.

Soviet Roots of Development Planning

The 20th century has witnessed two dramatic socialist failures: the fall of communism and the largest government- to-government transfers in the history of mankind. Communism, with its central planning of the economy, failed utterly to provide an acceptable living standard for the population and instead caused the moral, political, social, and economic collapse of all societies that implemented it. Meanwhile, Western development institutions spoon fed more than $1 trillion in foreign aid to Third World governments, tying their largess (in the form of grants and loans) to the implementation of development planning. That approach substituted foreign aid for domestic and foreign equity so that the investment process could be controlled by the recipient government's development plan drawn up by Western planners. Countries that implemented that approach are today experiencing a level of crisis akin to that of the Soviet Union.

Development planning was inspired in no small part by Western observers' hopeful interpretation of Soviet central planning. Hatred of the market led many Western economists to reject the capitalist development of their own societies and view the Soviet Union and Eastern Europe as a better model for development in the Third World. Highly exaggerated Soviet economic statistics were accepted by such economists as John Kenneth Galbraith and Ragnar Nurkse as evidence that rapid economic growth could be achieved by comprehensive economic planning.[2] Prominent Dutch development economist and Nobel laureate Jan Tinbergen wrote that "it should be recognized and expressly stated that the Soviet Union was the pioneer of central economic planning and has taught the world some of the possibilities in this field."[3]

Nobel laureate Gunnar Myrdal viewed the Soviet model "as fundamentally a system for the development of underdeveloped countries. This particular point cannot be stressed too much."[4] Nurkse even believed that the Soviet system of collectivization of agriculture offered advantages for the Third World. Nurkse maintained that the "crucial problem of collecting the food [sic] seems to be solved in Soviet Russia by the system of collective farms."[5] He also expressed the opinion that "it may be that the iron curtain is necessary for the maintenance of a high rate of saving and investment in the Soviet Union."[6]

Such statements sound absurd today. Yet, from the 1950s through the 1980s, the most influential economists recommended planning for the Third World, while those who saw the folly of the approach, such as British economist Peter Bauer, were shunned.

Third World Elites Used Development Planning to Entrench Their Power

In the 1950s and 1960s, Third World leaders were quick to adopt socialist development planning, as they correctly perceived an unprecedented opportunity to use foreign moneys to further entrench and expand their already extensive control over their economies, at the expense of society. They recognized that aid is fungible. For example, multilateral development bank loans can finance the growth of the state power company, while elites rake off national tax revenues for their own use.

Nobel laureate James Buchanan has observed that "rent seeking"--that is, competition for government largess and protected profits--emerges as a significant social phenomenon as institutions move away from ordered markets toward the near chaos of direct political allocation.[7] In the Third World from the 1950s onward, the organization of cartels and interest groups to compete for government protection and favors became all-important, because with one stroke the state could declare a monopoly or promulgate damaging regulations, thereby enriching or bankrupting private firms. Moreover, as bureaucrats could not possess the billions of pieces of information upon which individual entrepreneurs base their investment decisions, bribery of those bureaucrats emerged as the most efficient way to allocate government resources.

Government employees in developing countries came to believe that state property belonged to them. Given that such people manage property in their own interest, it is not surprising that bureaucrats became a new aristocracy, complete with Swiss bank accounts and palatial mansions, similar to the communist nomenklatura (establishment) described by Milovan Djilas in his classic book The New Class.[8] Graft and corruption proliferated as Third World elites skimmed off billions in purported commissions for themselves and duly squirreled them away in Western banks.[9]

Because government investments were not guided by any sense of market profitability, they did not generate the wealth to pay back the foreign loans. The $450 billion Latin American debt and Third World landscapes littered with bloated and inefficient state companies stand as monuments to that failed approach.

Development Planning in the Soviet Union

In the 1990s, in a bizarre turn of events, Western experts are pushing debt-financed development on the Soviet Union itself. Western governments are rushing to prop up the Soviets' collapsing planned economy with billions of dollars in aid, consisting of direct aid, export credits, and loan guarantees. As of late 1990 the Soviet Union had received commitments of $5.4 billion in government-guaranteed export credits and commercial loans from France and Italy.[10] Canada had committed $1.3 billion in food aid. In December 1990 the European Community approved nearly $2.5 billion in emergency aid and technical assistance. As of early 1991 the German government had guaranteed about $9.5 billion in private German bank loans to the Soviet Union (in addition to $8.5 billion in grant aid to support the relocation of Soviet troops from the former East Germany).[11] The Bush administration, for its part, in December 1990 approved $1 billion in export credit guarantees for Soviet government purchases of U.S. farm commodities and $300 million in export insurance and loan guarantees from the U.S. Export-Import Bank to support nonfarm exports. For 1991 alone, hard currency aid pledged to the Soviet Union totals $16.9 billion.[12]

To forestall collapse, the Soviet Union needs to establish private property and a market economy. As has been the case in the Third World, foreign aid does not help to reorient economies, and in the case of the Soviet Union, it will merely serve to entrench the communist old guard at the expense of democratic reformers. Because aid is fungible, it frees resources to be used however elites wish. In January 1991 Western aid served to prop up the Soviet elite's living standards while freeing the repressive apparatus to raid other resources for the bloody crackdown in Lithuania.

The Internal Affairs Ministry and the KGB (state security police), along with such other bastions of communist thinking as the Ministry of Defense, the Customs Administration, and transportation organizations, have been put in charge of the distribution of direct aid.[13] Numerous Soviet press reports detail how shipments of humanitarian aid have rotted at ports for lack of transportation to their final destinations and how aid has been diverted into the black market.[14] Although it is true that the state distribution system has broken down, the main purpose of centralized control is to distribute the largess to politically reliable groups. Perhaps that explains why many Soviet reformers have said that foreign aid is not needed,[15] while officials have proclaimed their thanks to Western donors.[16] If the Soviet authorities truly wanted to ease food shortages, they would immediately allow private ownership throughout the economy, legalize the informal distribution system, and free farmers and other producers to produce according to the wishes of consumers. Store shelves would fill without resort to foreign aid.

Moreover, the Soviet central government's current campaign against "economic saboteurs," reminiscent of Stalinist tactics, is not aimed at the arrest and conviction of the so- called Soviet mafia--Communist party members, ministry officials, top factory bureaucrats, and other members of the nomenklatura who have built huge economic fiefdoms by seizing effective control of state assets.[17] In a recent talk in Washington, D.C., Moscow mayor Gavriil Popov confirmed that state of affairs:

The KGB has been authorized to inspect the papers of privately owned businesses, but they will not inspect the papers of businesses owned by the nomenklatura. They will inspect and hassle their competitors. . . . What kind of free market can it be if one group enjoys the patronage of the govern ment and another group is continually hassled by the government?[18]

Lending Institutions Misinterpret Roots of Failure

The Soviet economy is a failure because Mikhail Gorbachev's five years of perestroika and glasnost have not eliminated the linchpin of communist economic organization: production to meet gross output quotas. Piecemeal economic reforms have served only to disrupt the decrepit state distribution system while blocking the establishment of a market economy, and the result has been chaos. Severe shortages of even the most basic necessities such as milk, butter, eggs, and sugar now afflict the Soviet republics. The Soviet press daily contains reports of meat, vegetables, and other foodstuffs rotting for want of transportation to final destinations.

In December 1990 the IMF and World Bank--the same multi- lateral institutions responsible for the development planning approach that devastated Third World economies--published a study of the Soviet economy.[19] (The Organization for Economic Cooperation and Development and the new European Bank for Reconstruction and Development [EBRD] also participated in the study.) It hardly seems appropriate that bureaucracies such as the IMF and the World Bank, which themselves operate like Soviet factories, be entrusted with the task of proposing a program for reforming the world's most overbureaucratized society. Indeed, the study reveals that both of those international organizations fail to comprehend the role of private property in the development of a market economy and thus do not understand why the Soviet economy failed.

The study's finding that "nothing will be more important to the achievement of a successful transition to a market economy than the freeing of prices to guide the allocation of resources," is incorrect.[20] The Soviet economy is irrational because it is based on gross output production to meet plan quotas instead of production to meet consumer market demands. Freeing prices will not lead to a market economy if labor and capital are not free to flow to their most profitable uses and continue to be forced into production to meet state quotas. The gross output system must be eliminated, and producers must produce for the consumer market. The establishment of private property is critical because bureaucrats are not entrepreneurs, and by definition, they allocate resources according to political criteria, which leads to waste and inefficiency. Bureaucrats must cede control over resources to owners, who will allocate resources according to the best available return. Only in such a system can freely floating prices serve the dual function of limiting the demand for goods and stimulating greater supply.

The international development institutions do not understand the political dimension of the requirements for price reform. There cannot be markets without private property. If prices are freed first, some will rise and some will fall. Higher prices would bring cries of profiteering, and allowing higher prices to be imposed on a Soviet population that has yet to see any material benefits from perestroika would be political suicide for democratic reformers. The prices of useless goods produced by many factories would drop, leading to unemployment or large deficits. Both situations would demand readjustment, which would deflect attention from privatization. The prices would not be free-market prices, because without private property, resources are not free to seek their best uses.

In the absence of a capital market, the value of capital cannot be derived from the value of the products it is being used to produce. A high-priced product might simply reflect scarcity of supply because capital cannot flow into production of that product, whereas a low-priced product does not mean the capital producing it is of low value, but rather that an excess amount of capital is devoted to that use.

Worse still than freeing prices before privatization is well under way would be imposing a centrally mandated price rise. Yet that is precisely what Soviet authorities implemented on April 2, 1991. Retail prices were raised (to new fixed rates) on 60 percent of consumer goods. Jacques Attali, chairman of the new EBRD, praised the centrally planned price rise as "a difficult and courageous step [and a] central element that will help the transition into private ownership."[21] Yet such purported reform in no way introduces market forces to steer resources to their most profitable uses, and it is producing an even more disaffected Soviet populace. The managed price rise only adds centrally planned inflation to the collapsing centrally planned economy.

The IMF and World Bank, in their study on the Soviet economy, recommend a program of price decontrol and wage controls combined with high taxes, fiscal austerity, monetary reform, privatization, and the conversion of large government enterprises into joint stock companies still under public ownership--a policy mix that will stifle production in the Soviet Union and create an adverse climate for the transition to a market economy. Such a program is in tune with the austerity programs adopted by debtor countries under the advisement and monitoring of the IMF. Typically, such programs entail plans for fiscal restraint (while keeping in place deficit-ridden state enterprises), currency devaluations, and tax increases to cut domestic demand.[22] If the plan is adopted, the Soviet Union is likely to face the same disincentives and economic regimentation that have destroyed the prospects of so-called developing countries.

The last section of the IMF-World Bank report reveals the kind of reforms that the two organizations--together with the EBRD--intend to finance. The study recommends a full-scale program of project assistance, contingent on the implementation of a comprehensive reform program, with foreign aid to be directed to the public and private sectors for use in infrastructure development, retailing and distribution, telecommunications, energy, the environment, transportation, agriculture, and banking. The study's authors recommend that the initial focus of aid be on technical assistance and food aid. Financing is also to be provided for "viable" state firms undergoing "severe transition problems." More general balance-of-payments assistance would be forthcoming upon adoption of reforms specified by the IMF, World Bank, and EBRD.[23]

To international bureaucrats, the establishment of private property rights in the Soviet economy is secondary to price reform in the creation of a market. In conversations with MDB officials, one still hears the belief reiterated that ownership of the means of production does not matter, that a unit of capital in the hands of state companies produces the same output as a unit of capital utilized by private companies. Perhaps the lingering influence of such thinking accounts for the IMF-World Bank study's emphasis on reorganizing many state enterprises and ministries rather than privatizing the entire economy. The study does recognize that capital is not allocated efficiently in the Soviet Union but concludes that price reform is the solution.[24]

Private property is essential to reform, and getting widespread property rights into the hands of the people is critical to breaking the power of the hard-line Communists. Today a battle over property is raging in the Soviet Union, and it is not over privatization per se but over who will enjoy the benefits of private property. Nomenklatura managers in control of parts of state firms and agricultural collectives commonly cease operations only to reopen as "private" cooperatives. Indeed, Communists seem bent on eliminating any collective rights to their de facto property; their behavior is similar to that of medieval European lords who undertook the enclosure of property to eliminate communal-use rights.

Although it is tempting to applaud the fact that privatization is at least proceeding, albeit in a decidedly unjust manner, the actual process of privatization leaves a lot to be desired. In the industrial sector, a so-called private cooperative uses a state enterprise's facility, equipment, and other inputs and sells its output back to the state enterprise. In most cases the cooperatives use the state facilities and inputs either with minimal compensation or, very often, free of charge. Since there is still no legal basis for individuals to own capital goods, the private cooperatives give individuals the opportunity to extract the rents of capital (even to fully deplete the capital) but do not subject them to the responsibilities of ownership. Nobody protests the depletion of capital because in the Soviet system there are no advocates for capital--only exploiters of it.[25]

Moreover, the Soviet people are becoming increasingly disaffected as they witness the standstill of official economic reforms and the old-guard Communists throughout the country taking full advantage of their control over state resources to charge ahead with de facto privatization in their own behalf.

Leaving privatization for last will spell disaster for Gorbachev's (or any future) government. The longer formal privatization is put off, the more chance the apparatchiks will have to plunder state property and obtain squatters' rights. The IMF and World Bank recommend sales of state property; yet in the absence of private property, there is no basis for the valuation of state enterprises. In addition, the public knows that black marketeers and former Communists would buy up the property.

Democratic reformers--in and out of government--should immediately set out a plan for giving property to the people.[26] That would provide politicians with a platform that would obtain popular support immediately, and widespread dispersal of private property would quickly generate the formation of markets. The easiest and fastest way to privatize and realize a campaign promise to give away property would be to convert Soviet firms into joint stock companies and issue a percentage of shares to be given away. Once a large enough proportion-- perhaps 30-40 percent--of property is in private hands, the government should announce that it will sell most of the remainder. People will immediately begin to estimate the value of their shares, and a market will form establishing prices. Then, the remaining shares can be sold.

Conclusion

Tass reported favorably on the IMF-World Bank study, and Andrey Bugrov, deputy head of the Soviet Foreign Ministry's Directorate for International Economic Relations, was pleased to note that the two organizations recommended the maintenance of the Soviet Union as a single economic unit, with one national monetary system, a single customs border, and common economic management rules.[27] Some democratic reformers joined officialdom in praising the report because they misinterpreted the report as promoting capitalism.

Other reformers believe the plan would pave a path for the Soviet Union to join the Third World in failures of development planning. They believe the Soviet Union, or the individual republics, desperately need the example of real capitalists-- Western venture capitalists, business management experts, U.S. constitutional law experts--to implant a psychology of market economy among the population.

How can we expect Soviet reformers to understand what has to be done, when the schemes the West presents them with leave so much to be desired? The loans and advice of the IMF and World Bank have impoverished and indebted the Third World. The Bush administration and other Western governments should not push bureaucratically managed, debt-financed development on the Soviet Union.

Notes

(1) Leonid Timofeyev, Moscow Tass in English, cited in U.S. Department of State, Foreign Broadcast Information Service (FBIS), Daily Report, Soviet Union, December 26, 1990, p. 56.

(2) See, for example, John Kenneth Galbraith, "Reflections: A Visit to Russia," New Yorker, September 3, 1984, pp. 54-65; Ragnar Nurske, Problems of Capital Formation in Underdevel oped Countries (New York: Oxford University Press, 1953; reprinted 1962), especially pp. 43, 64, 76, 150; and League of Nations, International Currency Experience: Lessons of the Inter-War Period (New York: League of Nations, 1944; reprint ed by the United Nations in 1947, with a preface noting that most of the book, except pp. 143-61, was the work of Ragnar Nurske), p. 196.

(3) Jan Tinbergen, Lessons from the Past (Amsterdam: Elsevier, 1963), p. 24.

(4) Gunnar Myrdal, An International Economy: Problems and Prospects (New York: Harper, 1956), p. 144 (emphasis in original).

(5) Nurkse, p. 43.

(6) Ibid., p. 76.

(7) James M. Buchanan, "Rent Seeking and Profit Seeking," in Toward a Theory of the Rent-Seeking Society, ed. James M. Buchanan, Robert D. Tollison, and Gordon Tullock (College Station: Texas A&M University Press, 1980), pp. 3-15.

(8) Milovan Djilas, The New Class: An Analysis of the Communist System (San Diego: Harcourt Brace Jovanovich, 1982.)

(9) Numerous sources detail institutionalized corruption in Latin America attributable to the state-directed development approach. A sample follows. On Brazil: Mario Barros Junior, A Fantastica Corrupcao no Brazil (1982), Jos Osvaldo de Meira Penna, O Dinossauro (Sao Paulo: T. A. Queiroz, 1988); on Argentina: Jorge Bustamante, La Republica Corporativa (Buenos Aires: Emece Editores, 1988); on Venezuela: Carlos Ball, Libertad, Democracia y Corrupcion (Caracas: Ediciones Libertas, 1983; reprinted 1984); on Peru: Hernando De Soto, The Other Path (New York: Harper & Row, 1989).

[10] "G-7 Financial Assistance to USSR," U.S. Department of the Treasury (unpublished table), November 1990.

[11] The figure of $9.5 billion (15 billion Deutsche marks converted at the March 1991 rate of 1.6 marks per dollar) in cludes $3.2 billion in export credit guarantees, the guarantee of a $3.15 billion loan for balance-of-payments support, and the guarantee of a $2 billion credit to finance the withdrawal of Soviet troops from the former East Germany.

Source: German embassy official, Washington, March 1991.

[12] International Monetary Fund, World Bank, Organization for Economic Cooperation and Development, and the European Bank for Reconstruction and Development, The Economy of the USSR, December 1990, Summary and Recommendations section, pp. 15- 16.

[13] I. Zhagel, "We Pin Our Hopes on Others. . . How Foreign Aid Will be Distributed," Izvestia, December 6, 1990, union ed., p. 1.

[14] See B. Pipiya, "Urgent Matter: Sabotage Again?" Pravda, December 9, 1990, second ed., p. 1; A. Streltsov, "Commodity Trap; Why Is There Nothing There? Pravda, December 8, 1990, second ed., p. 3; Editorial report, "Vremya" newscast, Moscow Television Service, December 8, 1990; and Ye. Bovkun, "Why Is Western Produce Not Reaching Us?" Izvestia, December 18, 1990, union ed., p. 4.

[15] See "Estonian Officials Reject International Aid," Moscow Tass, December 11, 1990, as cited in U.S. Department of State, FBIS, Daily Report, Soviet Union, December 13, 1990, p. 77; and Boris Yeltsin, address to the Russian Congress, Moscow Radio Rossii Network, January 10, 1991, as cited in U.S. Department of State, FBIS, Daily Report, Soviet Union, January 11, 1991, p. 56. Boris Yeltsin believes Western aid is used as an agent of political control. See also Andrei Sakharov on aid, in "Soviet Union in Turmoil, Says Sakharov," Financial Times, June 21, 1989.

[16] See V. A. Gulyashko, deputy administrator for the affairs of the USSR presidential apparatus, in interview on Moscow Television Service, December 3, 1990, as cited in U.S. De partment of State, FBIS, Daily Report, Soviet Union, December 5, 1990, p. 49; and Lev Voronin, first deputy prime minister, statements reported by Moscow Tass, December 13, 1990, as cited in U.S. Department of State, FBIS, Daily Report, Soviet Union, December 14, 1990, p. 29.

[17] See Paul Craig Roberts and Karen LaFollette, Meltdown: Inside the Soviet Economy (Washington: Cato Institute, 1990), pp. 87-93.

[18] Speech of Gavriil Popov, president, Moscow City Council, at the Cato Institute, Washington, February 6, 1991.

[19] The United States and other Western governments meeting in Houston for the July 1990 G-7 economic summit commissioned the study from the IMF and World Bank, in conjunction with the Organization for Economic Cooperation and Development and the new European Bank for Reconstruction and Development.

[20] IMF et al., The Economy of the USSR, p. 24.

[21] Laurie Hays, "For Sick Soviet Economy, the Prognosis is Gloomy," Wall Street Journal, March 15, 1991, p. A-8.

[22] See, for example, "The Theory behind Devaluation and Austerity" and "The Breakdown of the IMF Model," in Mexico 2000: A Classical Analysis of the Mexican Economy and the Case for Supply-Side Economic Reforms (Morristown, N.J.: Polyconomics, July 1990), pp. 107-14 and 118-26.

[23] IMF et al., The Economy of the USSR, pp. 47-48.

[24] Ibid., p 37.

[25] Melanie Tammen, "Kleptocracy Capitalism in the Soviet Second Economy," Journal of Economic Growth (U.S. Chamber of Commerce), December 1990, p. 9.

[26] See Paul Craig Roberts, "Shatalin Can Work if Privatization Comes First," Wall Street Journal, September 20, 1990, p. A-14; and Edgar Feige, "Perestroika and Socialist Privatization: What Is to Be Done and How?" Comparative Economic Studies (Fall 1990).

[27] Timofeyev.