

## HALF OR FULL REFORM?

*Oleg T. Bogomolov*

### The Need for Radical Reform

What is now going on in the Soviet Union and Eastern Europe can be best denoted by the word "revolution." Up to 1989, the administrative system underwent partial changes. The basic principles remained intact: the leading role of the party, domination of the state form of ownership, and the monopoly of Marxism in ideological life. The first attempt to restructure did not satisfy the society, nor did it resolve the crisis state. On the contrary, it only aggravated the situation.

While new structures and mechanisms have not been established, the old ones have become imbalanced. The very idea of reforms under socialism has become discredited, and faith in socialism's possible renewal has weakened. The people's confidence in the ruling clique has lowered drastically, and explosive material has been accumulating. As a dangerous malaise has been pushed deeper underground, the threat of its sudden and violent outburst has become increasingly likely.

In the autumn of 1989 the people's movement exploded in the GDR, causing a wave of detonations in Czechoslovakia, Bulgaria, and Romania. Changes that took many months and even years in Hungary and Poland were accomplished within several weeks. In light of these events, it has become clear that the existing system cannot be improved by partial perestroika; the system has fully discredited itself. It is necessary to form a qualitatively new social organization that would ensure true social and economic progress.

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This change requires disassembling the command-administrative system and liberating the people from dogmatism and utopianism in politics and from an ideology that has become the main brake in the way of progress. Both economic and political spheres equally need radical transformations.

There are many signs that the 1990s will witness the formation of a new social structure in the Soviet Union and Eastern Europe. The structure's principal features will be the following: a market economy with characteristically diverse forms of ownership and their equality (including private ownership), free enterprise and competition, broad democracy and glasnost, political pluralism including the existence of several parties and a parliamentary opposition, ideological diversity, reinstatement of liberty and humanism as universal human values, and openness to the outside world. The countries with a relatively high standard of living and with historical traditions of a market economy and democracy can transit—with international assistance and a rapid involvement into global political and economic relations—rather smoothly to the new social system. We can expect this transition within the coming decade. The transition period in multinational states, like the USSR, and in countries experiencing an acute economic crisis and a sharp collision of confronting forces will be inevitably more painful and longlasting.

### The Speed of Transition to a Market Economy

How can we find the effective forms of democracy for a society that has no democratic experience? There is no relevant historical precedent of transition from totalitarianism to democracy, from an administrative-command economy to a market-oriented economy. The trial-and-error approach explains inconsistencies that will occur in the democratization and marketization of the Soviet Union.

Radical political changes are badly required to transform a frustrated centrally planned economy into a socially oriented market economy. The Soviet Union should choose its own way of transition toward a market economy, because Western experience is hardly applicable. The best option would be a gradual transition toward a socially oriented market economy while retaining basic democratic guidelines. Is that option possible? There is ample evidence to show how difficult it will be to avoid granting emergency powers to a government that would introduce market mechanisms and would implement unpopular measures in order to remedy problems of money circulation, prices, and the internal market in general. The

question is whether the majority of people will support such measures.

One should not underestimate anti-reform movements and protests by large sections of the working class against hardships during the restructuring period. Attempts to use discontent and economic difficulties as an excuse for martial law are possible. Zigzags in the transition period, however, would not change the prevalent trend of development toward a market economy and democracy.

Debate continues as to what methods should be adopted to remedy the Soviet economy. It is very risky to liberalize prices on the consumer and wholesale market, to abandon the administrative system for distributing commodities that are in short supply, to make the currency convertible, and to remove restrictions on imports in the present conditions. There are huge disproportions in the economy, labor discipline is falling, and contracts are not honored. Nevertheless, Yugoslavia, Poland, and Hungary are taking the risks. Those countries prefer to speed up the process of transition to a veritable market economy, which they regard as the best way to stimulate economic activity.

Since the beginning of 1990, the economic situation in the Soviet Union has deteriorated rapidly: gross domestic product and industrial production decreased by about 5 percent, gaps widened between the money supply and the commodity supply in the internal market, and a serious deficit in the current-account balance developed in the external market. Taking into account the worsening situation, our leadership concluded that the transition toward a market economy must be accelerated.

Finally, after two months of rumors, conjectures, forecasts, stubborn questions, and noncommittal answers, in May 1990 the government presented to parliament its program for transition to a market economy.

The question is more than ripe—it is long overdue. Problems of inflation, financial improvement, and ownership have permanently figured on the agenda. On repeated occasions my colleagues and I have had to state our views before the Presidential Council, the Council of Ministers, and the press.

I can say, regrettably, that our proposals have not been heard. The program submitted for discussion cannot be seen as an effective transition to a market economy.

### Preconditions for the Transition

To make market instruments operative, we must do the following: implement privatization of state ownership, guarantee equality of

diverse forms of ownership, undertake price reform and liberalize prices to develop an appropriate market infrastructure that will reduce a huge budget deficit, abolish monopolies and create conditions for competition, reduce the monetary overhang by selling some state assets to stabilize the banking system and improve the financial condition of enterprises, establish a real exchange rate, and ease import control. We must also compensate losses experienced by low-income people during the transition period. In my view, the integrity of all these measures forms the basic preconditions for transition to a market-type economy.

### **Flaws in the Government's Program: A Plan-and-Market Hybrid**

After reading the governmental proposals, I have the impression that whatever the government's idea of the market economy is, it is a kind of plan-and-market hybrid.

A market economy implies freedom to choose the seller and buyer. But why then does the centralized supply system (*Gossnab*) remain? A market means a mechanism for establishing equilibrium and, hence, the corresponding prices and self-regulation. But these mechanisms are almost invisible in the program. A market economy presumes that capital, land, housing, and labor become market commodities. Is this type of market economy in question? I strongly doubt it. Rather the question is one of a tailored commodity and consumer market, only the rudiments of which we have had so far. The market implies free competition and restrictions on monopoly, some elements of which are mentioned in the program, but no clear picture is seen here either. The accent on regulation essentially cancels all these freedoms.

For the sake of this quasi-market, we have been asked to bear immense sacrifices and to resign ourselves to what essentially amounts to a twofold increase in prices. The government says that it is opposed to withdrawing money through a currency reform. In the future, it is true, the government has promised to protect the population's deposits by raising the interest on them to between 4 and 9 percent. But inflation is already above this level.

I conclude that the presented program is purely fiscal in character and contains something that largely betrays its objectives: preserving the existing system. It puts all the costs, including those linked to the government's mistakes, on the population.

But this is only part of the problem. The program also has a built-in mechanism for inflation, namely, a system of indexation and compensation. Workers will have to be paid largely at the expense of

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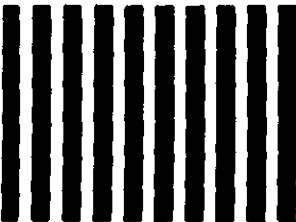
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enterprises, but enterprises will build these costs into their production costs, and hence into prices. The result will be the classical spiral of inflation.

It is impossible to improve the economy without abolishing the budget deficit, but it keeps growing. Today the deficit is as high as 100 billion rubles. The operation that was carried out to reduce the deficit by having recourse to empty loans from the enterprises can be regarded as no more than self-delusion. The deficit may rise to 150 billion rubles by the end of 1990—and no feasible solutions have been offered.

Perhaps the most important element lacking from the proposed program is an answer to the pivotal question: What will the incentives for labor amount to? The program defines the key feature of the incentive system as the increase in value of each worker's workplace. But what does this mean? Without a housing market and with the existing system of domicile registration, the program looks exactly like feudalism.

What is labor's incentive if we have just introduced a patently anti-market tax on people's incomes? This progressive tax portends not only an excessively steep scale, but also tax discrimination of individual, entrepreneurial, and cooperative activities. The tax was pushed through parliament on behalf of the government itself, which now proposes the same draconian taxes, only this time not on citizens' incomes but on enterprises' profits. When the profitability level reaches 30 percent, the whole of the "superprofit" is withdrawn into the budget. Where are the incentives? Who, under such conditions, will fill our market with goods and services? Most likely we face not merely the absence of a mechanism of incentives, but rather the imposition of a mechanism of anti-incentives. Moreover, people are getting caught under a double burden: growing prices on the one hand, and the impossibility for people to make money or to compensate for soaring prices with their work and initiative on the other. Increased prices will be more or less acceptable for people when they earn additional money through overtime, cooperatives, and new jobs in the private sector.

Lastly, complete uncertainty remains regarding transformation of ownership. The problems of privatization and freedom for producers have not been worked out; such mechanisms are either nonexistent or very doubtful.

It is proposed, for example, that housing should be redeemed in 10 to 15 years. The same with shares in enterprises, stores, and other trading facilities. I do not say that redemption is generally

impossible; yet I believe our citizens must be given their share of property not only through sales, but also in other ways.

All the talk about poverty notwithstanding, our country is sufficiently rich and the state possesses an immense amount of property. But people have been alienated from this property. We must return at least part of it to the people. Everyone has a share in national wealth. Not only is it advisable to think of how to transfer property to everyone, but also it is exactly now (as we pass over to a market economy) that such a decision would be particularly meaningful. People must have the right to sell their share of property, mortgage it, or to use it for obtaining credit. This right to property is important because the market cannot operate effectively without proprietors. Besides this, owning property could really protect people against soaring prices and inflation and could do this much more dependably than the compensating increments to wages in rubles, which are modest in size and empty in content. It may be worthwhile to make land privately owned by young families, or to give people housing, transport, production premises, and so forth for a very low price.

I believe that today the government has opted for an impasse-like road of transition to the market. All signs point out a desire to combine extra economic coercion with the market. At first, there will be more administrative control and less market, but then we will have less administrative control and more self-regulation. But a hybrid cannot work: The Hungarians, Poles, and Yugoslavs have attempted to make a hybrid work, but the result has been the same.

### Other Roads to Reform

Is there a different way out? Of course, there is; rather, there are two. The first is to cut the entry time to a minimum, to jump into a market economy all at once while simultaneously freeing practically all prices from control, that is, by resorting to what has become known as "shock therapy." As I see it, this road does not suit us.

The second course is to develop the market sectors in the economy by beginning primarily with the agrarian sector and to grant real freedom to the producer in developing production, establishing relations, and choosing partners. There are other sectors that are the most responsive to economic freedom and that quickly yield returns. Regrettably, the government's program again proposes developing agriculture on semi-feudal principles by introducing the tax in kind or, rather, by retaining the same state order. We must also take advantage of our public property and use it for the benefit of all people. The state should not behave like a dog in a manger: it must



share this property, thereby making the transition to the market—with its inevitable liberalization of prices—easier for people to endure.

What the government's program has managed to achieve, with its call for a one-shot increase in prices, is an unprecedented buying spree as people rush to buy existing goods before the administered rise in prices. Things should not be done this way; serious reforms require thoughtful actions not hasty programs such as the government has prepared. The government's program is simply not credible. A government that comes to the ruins of an economy and says, "There is nothing doing. Let us build together. Let us strain ourselves," has a right to call on the people to make sacrifices. But when the call comes from a government that has itself taken part in bringing about economic dislocation, that call for sacrifices cannot have a convincing ring.

The government's proposal to carry out a referendum on the question of price liberalization seems absurd to me. The population's attitude toward this reform is absolutely clear. People will say "no," and the government will have to resign. Why then organize a referendum? Is it because some officials think (and hope) that a "no" to the price hikes will signal a "no" to the very idea of transition to a market economy?

After a lively discussion the parliament refused to approve the governmental concept of transition to a regulated market and instructed the government to submit on September 1, 1990, a revised concept and a new set of reform measures for implementation.

Will yet another attempt to present a plan of marketization be satisfactory? Many signs indicate that there is a very strong inclination to a half reform. Because of ideological prejudices and indecision, the government is reluctant to allow private ownership of land and other means of production, to provide the citizens with assets as a result of a consistent and fair privatization, to abolish the ministries, and to radically reform the state finances and banking system.

Of course, the transition from totalitarianism to democracy and from a command economy to a market economy cannot be effected painlessly. The burden of problems accumulated over decades is still very heavy. But many difficulties could have been avoided if miscalculations had not been made in the concept of perestroika and its practical realization, and if we had not seen inconsistencies and indecision.

We began to introduce market principles and the self-financing of industrial enterprises without the prior formation of the necessary environment: a genuine wholesale-trade market, full-value money, sound price and banking systems, and appropriate tax and credit

regulations. As a result, the reforms did not get off to an effective start but created additional inflationary pressures.

It would have been wiser to have started from the other end—agriculture—with the emancipation of the agricultural producer from bureaucratic control and with giving the producer freedom of economic activity on the land. This emancipation would have called for leasing the land or transferring possession to family and cooperative farmers, together with gradually reducing the obligatory deliveries of agricultural products to the state and replacing that obligation with a system of free trade.

Instead of taking resolute measures to control the money supply and to balance supply and demand in the economy by a transition to a severe deflation policy, we continue inflationary policies. We amass expenditures for social needs, cross huge indebtedness of collective and state farms, and subsidize loss-making enterprises when we should cut spending on other budget items. The absence of a true monetary system that provides genuine purchasing power that is freely convertible into goods and, later on, into foreign currencies calls into question the entire economic reform in the country.

### A Rule of Law

The political life of society should allow for the creation of institutions for self-regulation and self-correction of the economy and for a trouble-free manifestation of its laws. There needs to be an improvement in the Soviet legal system. A rule of law needs to be established so that investors, workers, enterprises, and individuals can count on fair rules of the game and can foresee the consequences of certain economic decisions. One of the most important tasks will be to define in unambiguous terms the permissible forms and limits of political intervention in the economy. We are still at the very beginning of the road in this direction.

## GRADUAL VERSUS COMPREHENSIVE REFORM

*William A. Niskanen*

Oleg Bogomolov has made an acute analysis of the problems of the Soviet economic system and of the partial, tentative, and noncommittal measures to restructure this system during the past five years. And he has concluded, I believe correctly, "that the existing system cannot be improved by partial perestroika." Four of his insights, I suggest, are especially important.

### Positive Reform Measures

First, the steeply progressive tax rates on labor income and enterprise profits limit both the incentives for increased output and the willingness of the population to accept the necessary price reforms. In American terms, measures to improve the "supply side" of the economy are a necessary component of an effective economic reform.

Second, the Soviet Union has a huge amount of assets but little capital, primarily because individuals and enterprises do not have the opportunity to reallocate these assets to higher value uses. A comprehensive privatization of state property, which is presumably owned in the name of the people, is the necessary first step to create a capital market. Moreover, as Bogomolov correctly observes, the individuals and enterprises that receive this property must have the right, in turn, to sell it or to borrow against it.

Third, at some stage, the package of economic reform measures must be subject to approval by democratic processes but it is a mistake to subject individual measures, such as the necessary price reform, to a referendum. This is a controversial issue but, I suggest, Bogomolov's position on this issue is correct.

Finally, I wish to reinforce his conclusion that "one of the most important tasks will be to define in unambiguous terms the permissi-

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ble forms and limits of political intervention in the economy." The constitution of a free people must define the island of governmental powers in the ocean of individual rights. The Soviet Union is now best described as a set of islands of individual rights in an ocean of governmental powers.

### A Comprehensive Reform Strategy

My one major disagreement with Bogomolov is his recommendation for a gradual industry-by-industry reform, beginning primarily with the agricultural sector. There are two problems with this approach, one economic and one political. Each successive reformed sector would still face artificial prices and state controls on the necessary inputs from other sectors yet to be reformed. And the gradual approach would allow the opponents of reform to concentrate their opposition on each successive step. To illustrate my perspective, let me make a distinction between a comprehensive reform strategy and a "big bang" approach. A comprehensive reform strategy *initiates* all of the necessary reform measures at the same time but allows each measure to proceed at its own appropriate pace. A "big bang" approach, in contrast, attempts to maintain this same schedule for each of the reform measures, an attempt that I believe cannot succeed.

Many years ago, Friedrich Hayek demonstrated the difficulty of maintaining a credible gradualism in economic policy, because the population cannot discern whether each step is part of a longer series of steps to which the government is committed or is only a tentative step that may later be reversed. In the latter case, the response of the population would be much more cautious, slowing the effects of the reform.

We do not have a good theory or much evidence that bears on the appropriate *sequence* of reform measures, so some errors will surely be made. A comprehensive strategy that jointly addresses all of the reform measures, however, would minimize the costs of these errors.

A comprehensive reform strategy also puts pressure on all of the bureaucracies and opponents of the reform at the same time, reducing their opportunity and incentive to collude to oppose each successive step in a gradual reform strategy.

### Lessons from New Zealand

In conclusion, I would like to offer five lessons from the most ambitious economic reform of the 1980s—that by the Labour govern-

## COMMENT ON BOGOMOLOV

ment of New Zealand, as summarized by a senior representative of that government:

1. A country's crisis also creates a "window of opportunity" for fundamental change.
2. Electorates are more sophisticated about the importance of reform than most politicians believe.
3. Comprehensive reform is clearly easier than piecemeal reform.
4. Establish credibility early by choosing the first reform measures wisely, demonstrating that *reform works*.
5. Once a government is committed to reform, it can never move too fast to achieve it.

Those who wish to transform the Soviet system should pay special attention to Roger Douglas, the architect of the New Zealand reform.