RUSSIAN ECONOMIC REFORM:
IS ECONOMICS HELPUL?

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INTRODUCTION

Despite widespread agreement on the need for market-based reforms of the Russian economy, there remains extensive debate concerning the pace and process of reform.[1] The stakes involved in choosing the best reform path are immense, with the lives and liberties of nearly 150 million Russian citizens surely to be affected in some, perhaps large, measure. The additional consideration of the stability of a military superpower makes the Russian reform effort a worldwide concern. The humility requisite for entering the debate on Russian reforms brings to mind the words of Alexander Pope, "In tasks so bold, can little men engage...?"

Given that the task of Russian economic reform has fallen to men and women, sound economic advice to the decision makers becomes a high priority. A common perception, however, is that economics has little to offer when it comes to reform proposals. Western economic theory, which has found much success in analyzing the properties of various equilibrium states, admittedly has very little to say about the paths between equilibria. Furthermore, economic theory is more developed with respect to efficiency concerns than distributional issues. To the extent that successful reform depends on distributional effects, economic analysis may be less useful than political or ethical analysis. Even many economists question the ability of their discipline to add constructively to the reform debate. One leading expert on the Soviet economy sounds this theme:

> Economists, Eastern and Western, excel in analyses and criticism of existing centrally planned economic systems, and in extolling the virtues of a decentralized system relying heavily on markets. But they are almost no help in devising a strategy for the transition from the old to the new system. [Hewett, 1989, 18]

The contention of this paper is that economic analysis is vital to the formation of successful Russian market reform and that to date it has been misemployed regularly.[2] Basic economic principles, combined with an understanding of the pre-reform conditions of the Russian economy, can be particularly helpful in informing the debate over Russian economic reform.

Reform proposals of all types have run counter to some basic economic principles. This paper will later examine how issues ranging from inflation to monopolization in the former Soviet Union are still occasionally misdiagnosed, leading to suboptimal prescriptions for reform. A preliminary issue that must be addressed, however, is how this state of affairs has arisen. With the stakes so high, how could simple economic reasoning fail to be brought fully to bear on Russian economic reforms?

The answer lies in the nature of the economics discipline in Russia and the West. Economists in the former Soviet Union, by training and tradition, are generally unfamiliar with the methods of Neo-Classical economic analysis [Alexeev, Gaddy, and Leitzel, 1992]. Russian economists likewise are largely unacquainted with market systems. This lack of experience with the analysis of markets and the tools of Neo-Classical analysis has severely handicapped the reform efforts of Russian economists, despite their first-hand and professional knowledge of Russian economic conditions.

Western economists, alternatively, work under different handicaps, even as Western knowledge of Russian institutions increases dramatically. Two misperceptions leading to misguided reform proposals have been particularly common. First, the current state of the Russian economy is often taken at face value as a centrally-planned economy. The extensive system of informal arrangements that range from stealing time at the workplace to second-economy production is generally ignored. These extra-plan relationships are especially important in the partially reformed Russian economic system that exists today, since their increased legality has promoted their expansion greatly. A related point is that Russian official statistics still are often accepted uncritically, despite the revelations provided under *glasnost*.

Second, the measured effects of changes in the former Soviet Union are frequently assumed to accurately reflect actual effects. Starting from a system where relative prices in the state sector are largely meaningless, however, measured effects are not trustworthy.[3] For example, associating per capita gross national product (GNP) growth with an increase in welfare is problematic enough in a market economy. In a system with meaningless prices, such an equivalence becomes extremely difficult to defend. At least in a market economy the obvious exceptions are known — an increase in crime that triggers increases in the production of locks and other safety measures probably does not make society better off, even if GNP rises. But in the former Soviet Union, severe price distortions imply that an increase in the production of refrigerators may not add to welfare. With fixed prices, the real value of the inputs to refrigerator production is not easily ascertainable, nor is the value of refrigerators. So, the production of an additional refrigerator could represent negative value-added. The market forces operating in the West to curtail the production of negative value-added output are non-existent in a centrally-planned regime. Increases (or decreases) in GNP with fixed prices therefore are not good indicators of changes in the real value of underlying economic output.

The difficulty interpreting economic statistics in centrally-planned systems is often acknowledged, and then ignored, in reform discussions. One frequent example is the decrease in industrial production that is occurring in Russia. Statistics on declining industrial production generally are taken as signals of deteriorating economic conditions. Over-industrialization, however, was one of the most glaring inefficiencies of the centrally-planned system. Aven [1991, 187] notes that the value of excess metal-cut lathes in inventory in 1988 was 173 million rubles, and for electronic equipment, 107.7 million rubles. Under the circumstances, industrial production should be expected to fall. Without knowing what industries are declining, these statistics are not compelling evidence of economic deterioration.

Prior to the initiation of systemic reform, both Russian and Western economic analyses of the Russian economy were undermined by the theory of the second best. Distortions were (and are) so endemic to the Russian system that it was nearly impossible to predict with any conviction whether a given marginal policy change would add to or subtract from social welfare. Ironically, it is only now when systemic change is being considered that economics, in other settings best at analyzing marginal changes, becomes useful for Russian decision making [Alexeev, Gaddy, and Leitzel, 1992].

Applying basic economic principles to Russian economic reform reveals that problems often attributed to reform are already present in the current, partially-reformed Russian economy. The problems generally will manifest themselves differently, and perhaps more visibly after reform, but that does not mean that they have intensified. In many cases, reform offers the best hope of ameliorating the problems. Reform proposals that are too sensitive to these problems then may be misguided.

Consider the simple example of the high profits that often accrue to individuals working in the private sector. Many of these people are traders or workers in service industries, some of whom simply divert subsidized goods from the first to the second economy. Their large profits, especially, are an understandable source of discontent to many Russian citizens. Some reform proposals attempt to address this discontent by imposing highly progressive income or profits taxes, or by regulating pricing in a post-reform system. Such measures, of course, will undermine incentives for work or for the production of highly desired goods, one of the major problems with the pre-reform economy. Alternatively, relaxing the restrictions on prices and private enterprise will promote competition, reducing the rents from market activity.

The goal of this paper is modest — to demonstrate that there remain large potential gains to subjecting reform proposals to sensible economic analysis, when keeping actual Russian economic conditions firmly in mind. The issues are far from exhausted. Those issues that are raised here require further and deeper study, and many issues are omitted entirely. In the "bold task" of Russian economic reforms, this modest paper hopes to signal a high payoff to future research, while skirting another pitfall identified by Pope: "A little learning is a dang'rous thing."

The first section examines inflation and unemployment, the macroeconomic demons that haunt reform efforts. Pre-reform inflation and unemployment in

Russia is not well understood, and a more accurate picture of the initial conditions changes the outlook for reform. The size and distribution of income are examined in a similar vein in the following section. The extreme concentration of industries, quite large by Western standards, is the subject of the fourth section, while the fifth section focuses on the Western aid package that is being provided to the former USSR. These sections continue to emphasize the pre-reform economic conditions. The final section presents conclusions.

INFLATION AND UNEMPLOYMENT

The state sector of the pre-reform Russian economy was plagued by widespread excess demand for consumer goods manifested by lengthy queues, low quality, and haphazard availability of goods.[4] Generally this macroeconomic instability, while not without precedent in the former Soviet Union, is viewed as having worsened throughout the 1980s [Birman, 1990]. The root of the worsening shortages is often traced to expanding state budget deficits in the last decade [Birman, 1990; McKinnon, 1990]. As wages rose relative to the output of consumer goods measured at the controlled prices, the state budget deficit tended to increase, and households held more cash than was necessary to buy the existing stock of state-sector consumer goods. The excess rubles then took the form of increased savings, longer queues, and reduced availability of goods.

This macroeconomic instability was viewed by many Russian and Western economists as a major hurdle for reform, or even a sufficient cause to postpone reform. The General Secretary Mikhail Gorbachev shared this view, "The heaviest burden we have inherited from the past is the budget deficit...[T]he most urgent and immediate task...is to restore a balanced market and normal financial relations" [*Izvestiya*, 8 January 1989, 1, as appears in Birman, 1990, 25]. Reform proposals frequently called for an initial period of stabilization, prior to establishing free markets or privatizing state-owned enterprises.[5]

Why does macroeconomic instability, clearly problematic for the pre-reform Russian economy, also present an independent problem for free market reforms? Inflation (or the fear of inflation) is the usual suspect. With price liberalization, the excess privately held rubles would emerge generating a large one-time price increase and perhaps continuing inflation. Even worse, the initial inflation could reduce real tax revenues relative to expenditures (the Tanzi effect), exacerbate the government deficit, and fuel a hyperinflation [Dornbusch and Wolf, 1990].

Closer scrutiny, however, renders this inflationary logic less compelling [Alexeev, Gaddy, and Leitzel, 1991]. The relevant prices for pre-reform Russian consumers generally were not the fixed state prices. Rather, the relevant prices reflected the costs of queuing and searching for goods in short supply. Such costs, though, were not captured in price indices. Of course, most consumer items were available on black markets at uncontrolled prices. Since the marginal consumer was presumably indifferent between first and second economy purchases, black market prices, sometimes many multiples of the nominal state price, were a better reflection of the relevant prices facing consumers. While a free market reform may well result in generally higher nominal prices in the (formerly) first economy, and hence a higher measured rate of inflation, there is no reason to expect the relevant prices for consumer goods to increase in general.[6] The dead-weight loss of queue-rationing will also be eliminated.

Further links in the logical chain connecting macroeconomic instability to dire consequences arising from inflation under reform are equally suspect. Why should the one-time measured price increase that accompanies price liberalization convert into a continuing inflation, assuming that the government maintains a prudent monetary policy? Even if there is inflation, is this too high a price to pay for the many benefits that accompany free markets and privatization? Macroeconomic instability already created significant inflation in the pre-reform Russian economy. Why should a post-reform inflation be any worse? Privatization and free markets will encourage enterprises to engage in cost-saving measures — an incentive largely missing from the pre-reform Russian system — helping to check price increases. Dishoarding of goods inventories by both consumers and producers is also anti-inflationary.

The strain that inflation places on government budgets likewise exists as much prior to as after reform. With market reform and privatization, the pre-existing, largely implicit system of public finance has to be replaced.[7] As the profit incentive is restored via privatization, the tax base eventually will rise under a market system. Subsidies, which account for a large part of government expenditure, will be reduced substantially.[8] With conversion, military expenditures will also decrease. An increase in the Russian state budget deficit is not a necessary accompaniment to market-oriented reform. Following the Polish "big bang" on 1 January 1990, the state budget enjoyed a surplus in 1991.

The reality of pre-reform Russian inflation therefore involved the following elements: a large second economy with free prices, substantial repressed inflation, a lack of macroeconomic balance that rendered conventional price indices meaningless, and an implicit system of public finance that had to be overhauled as part of any significant reform effort. Together, these elements suggest that inflation is not a problem exclusive to reform and that well-designed reforms need not result in an inflationary outburst.

While inflation is a major concern for reforms leading to price decontrol, privatization invokes the perhaps even more chilling specter of widespread unemployment. Unemployment historically has been quite low in the former Soviet Union, well below typical unemployment rates in Western market economies.[9] Without the implicit and explicit subsidies that they traditionally received, many privatized enterprises could become bankrupt. Until free markets are established, though, it is impossible to know which enterprises will pass the market test. Even enterprises that are solvent post-reform may downsize their labor force, since labor hoarding had been a persistent characteristic of the Russian economy [Nove, 1986, 224]. A rapid privatization will probably lead to a large jump in measured unemployment.

As with inflation, the prospects for unemployment are tempered somewhat by considerations of real as opposed to measured effects. While measured unemployment is currently low in Russia, there is a substantial degree of underemployment. Many Russian workers languidly produce goods which should not be produced. The value of their marginal product may be very small and possibly negative, so these workers are already being subsidized. In other words, they are already to some degree unemployed, though in a disguised fashion. When market reforms and privatization are introduced, the disguises disappear. Measured unemployment will then rise quickly, though the actual amount of unemployment will suffer a less severe increase [Leitzel, 1991].

The argument that the perception of increased unemployment during the transition largely reflects a movement from repressed to open unemployment, without additional economic costs, requires an absence of large distortions in the economy [Leitzel, 1992]. If distortions such as low fixed prices for energy or other subsidies remain, then the "wrong" firms may be the ones to go bankrupt, and increased measured unemployment will carry additional costs. Distortions caused by government controls should be largely removed before state-owned enterprises are faced with hard budget constraints, to ensure that only economically nonviable firms cease operations. Increases in the measured unemployment rate then will represent mainly a change from repressed to open unemployment, without increasing the overall monetary cost of unemployment.

The newly unemployed workers may not be out of work for long. The emerging private economy, which already employs 40 percent of the non-agricultural labor force, will be able to absorb quickly many of those who lose their jobs [Starr, 1993, 56]. Employment may rise particularly quickly in those areas that have been relatively neglected under central planning. Housing construction and maintenance, trade, and the service and consumer goods sectors are such candidates which witness the Kiosks that have sprung up throughout major Russian cities. Another feature of the Russian economy that may change with reform and help to militate against increased unemployment is the high (by Western standards) labor force participation rate of women.

To the newly unemployed workers, the knowledge that they were virtually unemployed prior to the reform will not be much solace. At least they were getting paid before the reform. Without a job, they will require government assistance. The subsidization implicit in their existing underemployment and in their consumption of housing, energy, and many basic consumer goods, however, implies that the marginal expense of maintaining them on the unemployment rolls may not be large.[10] Furthermore, since the pre-reform implicit subsidies were not targeted, the total cost of "unemployment" compensation that maintains the same welfare level for newly unemployed workers should be smaller than in the old setting.

INCOME AND DISTRIBUTION

An important point often overlooked in discussions of reform is that Russia is a poor country by U.S. standards. Åslund [1990] estimates that Soviet per capita GNP was less than 1/3 that of the U.S. in 1985 and 1986, while Martanus [1990] reaches the conclusion that more than half the Soviet population lived beneath the U.S. poverty level. On the other hand, Russian citizens have accumulated a substantial amount of human capital relative to other countries with similar levels of income, at least partly due to the restrictions on alternative forms of investment. These two points must be borne in mind when thinking about "appropriate technologies" for Russian reform. Reformers frequently call for the development of market infrastructure. But the nature of the appropriate infrastructure may differ substantially from that in developed Western economies

A major concern of the Russian public is that market reform will lower its living standards. Of course, the relative success of market economies versus state-controlled economies, one of the driving forces for reform, suggests that in the long run, free markets will increase Russian living standards. Even in the short run, living standards may increase with reform, despite a fall in measured GNP. Closing inefficient factories that make goods that are not wanted by consumers will lead to a fall in measured GNP. But given market prices, bankruptcy means that society is better off with those businesses closed. Their inputs (their costs) are more valuable than their outputs (their revenues), so they should not be operating. Again, the disappearance of long lines is another boon to living standards that will not be captured in measured GNP; another is the reduction in wasteful forms of rent seeking.

Perhaps the most important influence on living standards in transitional Russia is the increase in private economic activity, generally unrecorded in official statistics. A recent survey indicates that on average, nearly two-thirds of the monetary income of Russian households is earned outside the primary place of employment [*Informatsionny byulletin*, 1993, 74]. Non-monetary compensation is also substantial. Together, these components of income, frequently informal and outside the purview of the statistical authorities, render the official income statistics virtually worthless. This should also be kept in mind when interpreting statistics that purport to provide a comparison between Western and Russian incomes. A not infrequent claim, for example, is that the average Russian earns the equivalent of $10 per month. Not only does such a figure ignore unofficial income, it is generally reported without additional information that could alter its interpretation: for example, the apartment rent paid by such a Russian comes to 10 cents per month!

The most elementary economic principle, that there is no such thing as a free lunch, is occasionally overlooked in discussions of Russian living standards and reform. Aggregate net subsidies are, of course, zero in Russia (absent foreign aid and possible foreign trade imbalances). The elimination of subsidies, in itself, will not cause average living standards to fall. Partial reforms, however, where some prices are controlled while other prices are freed and managerial discretion is increased, can lead to falling average living standards. The tropical flowers grown in Polish hothouses, an industry made profitable by a large subsidy on coal for heating, are a telling instance of the large distortions that can arise with partial reform.

Even if inflation, unemployment, and the potential changes in living standards are not obstacles to reform in the aggregate, their distributional effects (or feared distributional effects) may harm enough people to make reform politically untenable.[11] The raising of state sector prices will tend to hurt those who are endowed with relatively more time than income, such as pensioners or people without jobs. Workers who lose their jobs due to privatization will also suffer short-run consequences. Explicit unemployment compensation must be set aside to help these people in the transition. Inflation has already virtually destroyed pre-reform savings that were held in the form of domestic currency.

Many Russian citizens had ambiguous feelings towards the socialist system. In their activity as consumers, shortages and queues were very frustrating. For employees, however, the situation was more tolerable. Many employees did not have to work diligently, and yet they were in little danger of becoming unemployed. The sellers' market that is frequently invoked to describe the condition of the Russian consumer goods market also characterized the Russian labor market. Employees could steal time or goods from their workplace, generally with the complicity of management [Gaddy, 1991]. Much of their employment compensation was, and remains, in-kind. For example, a large percentage of housing in Russia is allocated through enterprises. For employees who are not particularly ambitious, then, the pre-reform employment system had many benefits, though high official pay was generally not one of them.

Market reform and privatization will wreak large changes in both the consumer and producer spheres. Consumer frustration from lengthy queues and haphazard availability of goods will virtually vanish. Diligence will become expected (and rewarded) at work. The less visible losers from reform, then, will be those who are currently able both to capture a large share of rents and be relatively shielded from the problems of consumption. These are likely to be employees of enterprises with managers who are well-connected and who can therefore provide their employees with higher pay and more of the scarce in-kind benefits.[12] It is not obvious how to protect their relative standard of living, at least as long as they remain employed. But since such employees are generally not poor by Russian standards, there is no compelling reason to protect their relative status, unless such potential losers are powerful enough to block reform efforts.

More generally, market controls combined with incomplete information in the pre-reform Russian system created rents. These rents were frequently captured by those with access to privileges or private information, which were available in some degree to almost all employees at the workplace.[13] Market reform will reduce the available rents. People who were previously collecting large rents are therefore likely to oppose any reform. These people may in fact have had to pay for their rents in advance (for example, by bribing an official to get a job with large rents), so they may view the disappearance of their rents as particularly unfair.

Another distributional issue concerns the beneficiaries of the privatization of state-owned enterprises. The Russian official privatization is heavily biased towards existing managers and workers [Leitzel, 1993]. Why should one individual benefit relative to another just because he or she was fortunate to have a job at an enterprise that was particularly valuable post-reform? These issues are complex, and no attempt will be made to resolve them here. It should be noted, however, that in many cases it may be difficult to prevent current employees and management from liquidating the capital of an enterprise if they are facing privatization to outsiders at some future date.

Distributional concerns are clearly of utmost importance. At the same time, reforms cannot be blamed for previous injustices. Furthermore, the actual distributional effects of reform are probably impossible to know in advance.[14] Maintaining the status quo carried some severe distributional consequences, namely continuing to advance the welfare of one-time Party favorites and black marketeers. (Many of these people shielded themselves against adverse effects of reform through purchases of goods or foreign currencies.)

A Russian preoccupation with not only avoiding maldistribution, but also ensuring nearly equal distribution, has been cited as a major impediment to reform [Smith, 1990]. If meaningful differentials in welfare are not allowed, then reform will surely fail. Two points are relevant, here, however. First, despite the Russian culture of equality, there are already substantial inequities. While taking the value of privileges and second economy behavior into account is difficult [Matthews, 1986], the Russian income distribution is generally considered to be similar to that in Britain [Atkinson and Micklewright, 1992]. Second, as noted in the introduction, the concern with equality may simply reflect the pre-reform situation, where income gains often were due to undeserved rents. A market reform changes the nature of, and perhaps the attitude towards, income differentials.

MONOPOLIES[15]

The concentration of Russian industry is substantially greater than that of the United States.[16] Many goods are produced at only one, generally large, factory. The high degree of concentration of Russian industry has led to the suggestion that large enterprises be broken up prior to privatization. There are three main arguments. Firstly, privatization, especially through sale, is more difficult for large than for small enterprises. Secondly, absent the break-up of large enterprises, Russia would remain dominated by monopolists after reform, and the monopolists would then be largely free of state control. Prior to reform, output and prices, at least in principle, were centrally-determined. With privatization the management of the enterprises could make these decisions independently, leading to the output restrictions and monopoly pricing problems that have induced the regulation of natural monopolies in the United States. Thirdly, a large enterprise has bargaining power and enough large enterprises may be able to bargain exceptions for themselves so that privatization becomes meaningless.

As with inflation and unemployment, measures of the degree of concentration of Russian industry may be misleading. Largely because of the difficulty in disciplining state-owned monopoly suppliers, the amount of vertical integration in Russian enterprises (and ministries) is immense [Hewett, 1988, 170-76]. The situations in which an enterprise seems particularly overdependent on a single supplier probably have already been remedied internally, and perhaps informally, prior to reform. Furthermore, goods that are produced by a single civilian seller also may be produced in the defense sector. With the conversion of defense industries, these enterprises may emerge as new competitors.

Why should larger enterprises be more difficult to privatize than small enterprises? The possibility generally considered is that there are not enough wealthy citizens to become owners of huge enterprises. Of course, the enterprises will be sold in shares, not as indivisible units, so the new owners do not have to consist of a few wealthy individuals. Another consideration is that the social consequences of bankruptcy are much greater for large than for small enterprises. Bailouts of major corporations in the United States have occurred for precisely this reason. Once again, however, this problem is worse in the unreformed Russian economy. No doubt many large enterprises are candidates for bankruptcy, but until prices are free, it cannot be determined which ones. Now, all of the potentially bankrupt companies are sustained by the government. Post-reform, at least the government will know which enterprises are nonviable and then can select individually which ones to aid and which to let falter.

Privatization does not imply that the social costs of monopoly will increase. Large state monopolies in the pre-reform setting had a great deal of bargaining power in dealing with planners. They were therefore in a position to receive more inputs and lower output targets than firms in worse bargaining positions. With privatization, monopoly rents will take the form of reduced output (relative to competitive levels) and increased prices. While these monopoly rents will take a new form, they need not be any more costly socially than the monopoly rents in the pre-reform economy.

Monopoly in general is more of a problem without reform than with reform. Currently, downstream firms often are attached to one or a few suppliers. If they are dissatisfied with the performance of their suppliers and vertical integration is impossible, there is little they can do. With free enterprise, barriers to entry will disappear. Suppliers who fail to satisfy their customers will see competitors spring up. The Russian economy is quite large, so the prospects for the development of competitors are bright relative to smaller, closed economies. Competition also will be given a boost as reform increases the participation of foreign firms in the Russian economy. Eventually, the only monopolies that will remain to require government regulation will be natural monopolies.

Finally, two elements of monopoly actually may be beneficial for reform efforts. First, if monopoly pricing practices would generally be available after reform, and these high prices translate into high profits, then sales of monopoly firms during privatization should find plenty of buyers. Foreign firms should also be eager to enter such potentially lucrative markets. (The high profits of monopolies also present a tradeoff with the concern over the increase in open unemployment, as profitable monopolies will not go bankrupt.) Second, the breakdown in economic coordination that is feared from reform will be ameliorated with industrial concentration. Downstream firms know precisely with what supplier they will have to continue to deal, and new enterprises should also be able to quickly learn where inputs are available.

THE WESTERN AID PACKAGE[17]

On 1 April 1992, Western leaders announced a $24 billion aid package to the states of the former Soviet Union [Devroy, 1992, A1].[18] The main components of the aid package are $18 billion in balance-of-payments support and a $6 billion ruble stabilization fund. As with inflation, unemployment, living standards, and monopoly, the pre-reform situation is crucial in determining the potential impact of the Western aid.

Consider first the balance-of-payments support, which is equivalent to giving the former Soviet states Western goods. What form the goods take, whether food or clothing or medical supplies, is largely irrelevant. Such direct aid is fungible, in the sense that aid received in the form of food, for instance, frees internal Russian resources for other purposes.

The pre-existing debt owed by the former USSR to the West greatly alters the impact of Western aid. Balance-of-payments support may not be particularly costly to the West, at least in the aggregate. The states of the former Soviet Union owe some $60-$85 billion to the West — a debt that they are having difficulty servicing. Indeed, the repayment of principal due on debt was postponed in December 1991 [Roth and Carrington, 1991]. The situation is further complicated by the disappearance of the entity — the USSR — that was the original borrower.

The existence of this potentially unrecoverable debt implies that Western aid to Russia may largely be returned to the West in increased debt repayment.[19] Aid effectively will transfer funds from the International Monetary Fund (IMF), World Bank, or Western governments to Western banks, simply passing through Russia.

As opposed to balance-of-payments support, the ruble stabilization fund is designed to work in an indirect fashion. If a ruble stabilization fund achieves its purpose, it will not actually be used — with a stable ruble, the extra foreign exchange comprising the stabilization fund will remain in place. Such forms of indirect assistance are therefore conceptually different from direct aid.

A ruble stabilization fund is envisioned to be coordinated with a program to make the ruble fully convertible on current account transactions. Combined with a largely unrestricted trade regime, ruble convertibility promotes the importation of world relative prices and increased foreign trade and investment.

Nevertheless, full ruble convertibility is not an indispensable component of reform. The foreign trade regime generally plays a minor role in promoting economic growth — internal policies are more important [Dornbusch, 1992]. A substantial amount of foreign investment can occur without full ruble convertibility. Many foreign joint ventures, for example, are already operating in Russia. A similar point applies to foreign trade. There is already a good deal of foreign trade in Russia, though the break-up of the Council for Mutual Economic Assistance (COMECON) has resulted in a major trade reduction. Full ruble convertibility would increase foreign trade and investment and benefit the Russian economy. Policies that rationalize the large internal economy, however, are almost sure to produce gains that swamp the effects of improvements in foreign trade.

Even the importation of world relative prices may not confer large gains on Russia. There is evidence that the state-controlled relative prices were largely consistent with world prices, though with some notable exceptions such as the prices of housing and energy [Lazear, 1991]. The important reform is to ensure that domestic producers have an incentive to respond to market-determined prices.

For these reasons, full ruble convertibility is not a pressing issue. While full convertibility would undoubtedly be beneficial, needed market-oriented reforms can proceed and generate large improvements in the Russian economy, even without ruble convertibility.[20]

CONCLUSIONS

Economics has more to offer the debate on Russian economic reform than simply noting the efficiency properties of free markets. Basic economic principles applied to actual Russian economic conditions shed light on debates concerning issues as diverse as inflation and Western aid. The theme that emerges from such applications is that many difficulties that often are attributed to reform are already present, though in different guises, in current Russian circumstances and would not be made worse, even temporarily, by economic reform.

NOTES

I would like to thank my frequent collaborators, Michael Alexeev and Clifford Gaddy, for many fruitful discussions and insights concerning the Russian economy. Helpful comments were provided by Steven Pressman and J. M. Stuart. Parts of this paper were prepared at the Hoover Institution, where I was a 1991-92 National Fellow, and to which I am most grateful. All errors and opinions in the paper are my own.

1. The destination of a Russian reform effort also remains an issue, with continued calls for a form of market socialism or other third ways. The analysis in this paper presupposes that the goal is to become a Western-style market economy. While there are many differences among Western industrialized market economies, they are minor relative to the difference between any Western market economy and the current Russian economy. The precise destination therefore will not be further specified here.

2. Evidence for the contention of the value of economic reasoning comes, ironically, from Dr. Hewett's own work [Hewett, 1988], among other sources. Kornai [1990] is an outstanding example of the application of basic economic reasoning to Eastern European reform.
3. Lipton and Sachs [1990] emphasize this point with respect to the Polish economy.
4. These conditions were not ended by the 2 January 1992 state-sector price increases, since prices were not fully liberalized. On the extent to which this reform fell short of full liberalization see Åslund [1993].
5. This sequencing was part of the reform plans of both Abalkin and Ryzhkov. See the discussion in Ofer [1989, 108]. The Gaidar reforms of late 1991 and 1992 moved ahead without first achieving macroeconomic balance.
6. Osband [1991] demonstrates how typical price indices are biased upwards, thereby overstating inflation, during a price liberalization.
7. McKinnon [1990] offers an overview of the pre-reform Soviet public finance system. See also Nove [1986, Footnote 235].
8. Ofer [1989, 134] notes that planned subsidies in 1989 totaled more than 11 percent of GDP.
9. Hewett [1988, 42] suggests that Soviet unemployment rates in the mid-1980s were under 2 percent.
10. It should also be noted that Western standards do not apply to the amount of unemployment compensation [Fischer and Gelb, 1990, Note 15]. Living standards in Russia are approximately one-third of those of the United States, so unemployment benefits can be correspondingly lower — though coming from a smaller GDP, they may be an even larger factor for the Russian economy.
11. Determining the likely winners and losers from reform is not an easy task, though Alexeev [1991] makes some progress in the framework of a theoretical model.
12. Retail trade employees are another class of citizens who may lose some rents from reform [Alexeev, 1991].
13. The capture of rents from informational advantages is a standard result in agency models involving moral hazard and adverse selection [Laffont and Tirole, 1986].
14. This uncertainty may itself be a barrier to reform [Fernandez and Rodrik, 1991].
15. A fuller treatment of Russian monopoly is provided in Leitzel [forthcoming].
16. In 1988, the market share of the single largest Soviet producer exceeded 50 percent for over 60 percent of product groups; for the U.S. in 1982, the four largest producers exceeded a 50 percent market share in less than 30 percent of 4-digit manufacturing industries [Kahn and Peck, 1991, 65].
17. This section draws on Leitzel [1992], which presents a more extensive analysis of Western aid to Russia.
18. The aid package has been revised several times since, but the basic structure is unchanged.
19. In a letter to the *New York Times* on 7 April 1992, Jeffrey Sachs notes that Russia received $15.6 billion in aid in 1990-91, and paid $13.1 billion of the $15.5 billion on accumulated interest and debt that was due during that period. Sachs writes, "Overall, almost no resources came to Russia in 1990-91, after taking account of debt payments."
20. In pursuing ruble convertibility, it is unclear whether a stabilization fund is itself a sound policy [Leitzel, 1992].

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