ВОПРОСЫ ТЕОРИИ

Permanent Crisis in Russia: Systemic Roots

Steven Rosefielde

For diverse ethical, political and cultural reasons Russia and China have chosen to construct market systems that are incompatible with the generally competitive principles sometimes advocated by international institutions like the World Bank and IMF. The generally competitive paradigm requires unfettered individual utility seeking, where participants abide by the fairness principle of the golden rule, buttressed by the rule of law. Russia and China have embraced the laissez-faire aspect of general competition, but rejected the golden rule, and the rule of law creating a system with acute institutional and moral hazards that have not only impaired productivity and efficiency, but destabilized the economy as well. This new Russian and Chinese model can be called authoritarian laissez-faire because it empowers various state dependent elites to freely and anti-productively maximize their own utility at the expense of others. The model superficially looks much like other market economies, but by modifying just a few axioms of the laws of demand, supply and equilibration, policymakers have created culturally approved systems with perverse properties that are resistant to constructive reform. Neither Russia nor China will be able to successfully compete with golden rule abiding market systems until they embrace the generally competitive rule of law, regardless of how statistics are doctored, or policymakers tinker with privatization, liberalization and stabilization.

The Russian financial crisis of August/September 1998 may not provide the "shock therapy" needed to achieve a self-sustaining transition to competitively efficient free enterprise[1], but it has stunned most western "transitionologists" into silence and emboldened others like the World Bank's Vice President and Chief Economist Joseph Stiglitz to accuse them of faulty theorizing[2]. Clearly those who pre-

---

Steven Rosefielde - Professor of Economics, University of North Carolina, Chapel Hill, member of the Russian Academy of Natural Sciences.

[1] Evgeny Gavrilenkov, "Permanent Crisis in Russia: Selected Problems of Macroeconomic Performance," Hitotsubashi Journal of Economics 40, 1999, pp.47-57.

[2] Joseph Stiglitz, "Wither Reform? Ten Years of Transition," Keynote Address, Annual World Bank Conference on Development Economics, April 28-30, 1999. Cf. Joseph Stiglitz, Wither Socialism?, MIT Press, Cambridge MA, 1994. In January 1999, the World Bank announced a new comprehensive development approach (CDF) for transition economies comprised of four principles: 1) stabilizing the economy and consolidating finances by solving so-

dicted that dismantling planning, freeing prices, semi-privatizing, privatizing, and empowering management and entrepreneurship would enable per capita income to recover to the 1989 standard by 1994, followed by rapid modernization were wrong. This mis-forecast has been blamed on inflation, but price stabilization achieved thereafter hasn't reversed Russia's economic decline.

What aspect of the theory did Jeffrey Sachs, Roy Laird and Anders Aslund get wrong? Did they misunderstand microeconomic principles? Did they misconceive the requirements of macroeconomic monetary stabilization? Perhaps, but it appears that their failure has deeper roots in their mis-conceptualization of the scope of economic behavior caused by a misguided desire to achieve scientific generality by disregarding cultural, political and ethical particularities. The prestige of western market, regulatory, administrative and planning theories lies in the twin claims that most markets are "workably" efficient, and where they are not, or outcomes require modification this can be "neutrally" achieved through sound, socially responsible regulation, administration and planning. The remedy for any economic malady from growth retardation to transition follows axiomatically: privatize, liberalize, stabilize, and efficiently govern. Of course advocates recognize that these policies may be opposed by various forces, including institutions, power elites, and criminals, but insist that their resistance will be overcome. Happy outcomes, subject to well known technical market imperfections are assured by vigorously debating implementation strategies, promoting democracy and fighting crime.

Close examination of these postulates however reveals that they are less plausible than western theorists contend. They assume that utility seeking is carried out efficiently with respect to discoverable potential by all individuals unfettered by anti-competitive, defensive and predatory compacts[3], guided by the Christian "golden rule": do unto others as you would have others do unto you[4]. Efficient, vol-

---

cial problems and curing structural weaknesses, 2) improving advice by drafting and implementing development policies through a partnership of governments, civil organization, private businesses, and international donors, 3) bolstering domestic political responsibility by making country's themselves, not donors the final arbiters of goals, timing, and the execution of development programs, 4) mobilizing development initiative by designing programs with a long term perspective, projecting a vision in its entirety, based on nationwide consultations and striving for the widest possible national concensus. See "Interview with World Bank President James Wolfensohn: The New Development Approach and the Transition Economies," Transition, Vol.10, No.3, June 1999, pp.1-4.

[3] Compassionate and altruistic behavior is encompassed by this concept, as are various forms of sharing, mutual support and reciprocal obligation to the extent that custom doesn't diminish the global efficiency of voluntary general competition.

[4] The origins of modern utility theory can be traced to the enlightenment where notions like "natural law," and John Locke's concept of voluntary harmonious "social contract" which secularized Christian religious precepts such as the golden rule in order to infer that the "invisible hand" would dependably generate favorable outcomes. If utility theory had been developed in the late romantic period at the end of the 19th century when natural law and harmonism were giving way to Nietzschean immoralism and psychologism, faith in the invisible hand would have seemed implausible. Abram Bergson, "A Reformulation of Certain Aspects of Welfare Economics," Quarterly Journal of Economics, Vol.52, 1938, pp. 310-34; Paul Samuelson, "Bergsonian Welfare Economics," in Rosefielde, ed., Economic Welfare and the Economics of Soviet Socialism, Cambridge UP, Cambridge, 1981, pp.223-266; Samuelson, "Optimal Compacts for Redistribution," in R.E. Grieson, ed., Public and Urban Economics, Lexington Books, Lexington MA, 1976.

untary, independent individual utility seeking assures that people act in their own interests within the limits of bounded rationality, without being manipulated by others; while the golden rule precludes people taking unfair advantage of others through market power, deceit, intimidation, subjugation and all forms of criminal misconduct. Favorable outcomes can also be attained on weaker premises by assuming that infringements of the principle of voluntary, competitive utility seeking only alter the distribution of income and wealth in socially approved ways («lump sum taxes)[5]). But this acquiescence is easily abused. Segments of society often are coerced into acting against their own independent utility maximizing interests (oligopoly, subjugation, etc.).

Theorists (especially game theorists) don't have any difficulty acknowledging such lapses, but are reluctant to consider the possibility that economic misbehavior can be systemic, and durably dysfunctional. As a consequence, their descriptions of the efficiency characteristics of western economies including those of America, Continental Europe and Japan tend to overstate real accomplishments, while they misunderstand the micro and macro operations of the laws of demand, supply and their equilibration in Russia and China.

Proper modeling of any economy, especially Russia and China, requires a clear recognition that while most of the axioms of the laws of demand, supply and their equilibration connected with individual utility maximizing (whether accomplished through markets or plans) apply in any regime, behavior may be systemically affected if only a single sub-axiom is modified[6)]. For example, if the demand side axiom of independent individual utility seeking is altered by egalitarianism, counterpart profit maximizing on the supply side may be replaced by egalitarian dividend maximizing with well known aberrant behavioral implications[7)]. Systems theory doesn't displace, or subordinate conventional micro and macroeconomic concepts, it investigates how relaxing and expanding postulates causes behavior to repeatedly deviate from predictions which assume perfect independent utility seeking, constrained by the golden rule[8)].

[5)] Socially approved interdependencies create two problems. First individuals may not act on their preferences because they hope to receive vaguely defined, indivisible benefits by imposing obligations on others. Second, the state may assert the right to regulate external economies and dis-economies, restricting free choice and mandating compensation, including welfare transfers. Both actions can be reconciled with independent, divisible utility optimizing by treating them as voluntary insurance compacts, but in practice usually impose involuntary restrictions which diminish economic efficiency.

[6)] Steven Rosefielde, Principles of Comparative Economic Systems: Foundations of Wealth and Great Power in the 21st Century, Addison, Wesley, Longman, forthcoming 2000, chapter 2.

[7)] R.W. Pfouts and Steven Rosefielde, "The Firm in Illyria: Market Syndicalism Reconsidered," Journal of Comparative Economics, Vol. 10, No.2, June 1986, pp.160-170. R.W. Pfouts and Steven Rosefielde, "Egalitarianism and Production Potential in Postcommunist Russia," in Steven Rosefielde, ed., Efficiency and Russia's Economic Recovery Potential to the Year 2000 and Beyond, Ashgate, Aldersgate, 1998, pp.245-67.

[8)] This approach is compatible with both the old institutionalism which stressed interdependent utility maximizing, and the new institutionalism which emphasizes imperfect independent utility maximizing, but only insofar as they enter into the larger causal tapestry. Western systems theory is founded on the concepts of utility maximizing and supply optimization, treating institutional factors as secondarily co-determinative. See John Harriss, Janet

In the Russian and Chinese cases the postulates of independent utility seeking, efficient collectivist utility seeking, and profit maximizing are violated by golden-rule unfriendly authoritarianism, and the remnants of involuntary Soviet era collectivist institutions. The elites controlling the state have a general idea of their personal and societal objectives, and aren't shy about exerting power, but no longer wish to comprehensively micro-direct the economy, preferring to delegate this responsibility in varying degrees to their former managerial agents, new entrepreneurs and the market. As authoritarians, the state elites resist the discipline of the rule of law. They also shun the creation of generally competitive institutions, which would jeopardize their power and privileges, preferring to retain collectivist vestiges from the Soviet past like communal and worker ownership, combined with managerial one-man-rule[9]. But under the new regime which can be aptly described as authoritarian laissez-faire, managers have expanded autonomy. In the Russian case most are no longer state agents[10]. They operate on their own behalf as minority co-owners, and natural adversaries of segments of the state elites, the state and other co-owners. Instead of dependably serving the purposes of the state elite as bonus incentivized, output maximizing Red Directors, managers find themselves enmeshed in a complex, fluid game where utility seeking frequently involves anti-competitive intrigues, profit sub-maximization, misappropriating revenues and assets, liquefying them and depositing the proceeds abroad. From time to time the state elite and managers collude for their mutual personal benefit, raising the possibility of re-subordinating managers to unified authoritarian control, but this apparently has not been the preferred adaptive trajectory for either party. While similar malfeasances occur elsewhere, Russia has been unable to restrain them within tolerable limits through the use of shareholder litigation, other legal actions, and effective market discipline.

Hunter and Colin Lewis, The New Institutional Economics and Third World Development, Routledge, London and New York, 1995, and Howard Stein, "Institutional Theories and Structural Adjustment in Africa," in Hariss et.al. Some practitioners of the new institutionalism include R. H. Coase, "The Institutional Structure of Production, American Economic Review, Vol.82, No.4, 1992, pp.713-720; Joseph Stigliz, "Markets, Market Failures and Development," American Economic Review, Vol.78, No.2, May 1989, pp.197-203; Oliver Williamson, The Economic Institutions of Capitalism, Free Press, New York, 1985. Relaxing and expanding postulates of general and imperfect competition to take account of cultural and political factors can also be reconciled with neo-Marxism. Cf. B Chavance, "Evoliutsionnyi put' ot sotsializma," (The Evolutionary Path Away from Socialism), Voprosy ekonomiki, Vol.6, 1999, pp.4-26 which provides an interesting analysis of the behavioral differences between the contemporary Russian and Chinese systems, and Iu. Ol'sevich, "Institutsionalizm - novaia panatseia dlia Rossii?" (Institutionalism - A New Panacea for Russia?) Voprosy ekonomiki, Vol.6, 1999, pp.27-42.

[9] The official rationale for these peculiar arrangements is to empower the economy through the integration of entrepreneurial markets with collectivist structures. But Russian and Chinese elites also have sought to modernize the management of power to facilitate their personal enrichment.

[10] George Kleiner, "Russian Enterprise Inefficiency: An Elasticity Test for Incomplete Profit Maximization," in Steven Rosefielde, ed., Efficiency and Russia's Economic Potential to the Year 2000 and Beyond," Ashgate, Aldershot, 1998, pp.209-18. A. Shleifer and R. Vishny, "Politicians and Firms," Quarterly Journal of Economics, Vol. 109, 1994, pp.995-1025. Cf. N. Barberis, M. Boyko, A. Shleifer, and N. Tsukanova, "How Does Privatization Work? Evidence From Russian Shops," Journal of Political Economy, Vol.104, No.4, 1996, pp.764-790.

As a consequence, Russia and China find themselves under assault from three distinct types of "moral hazard." First, in the absence of effective democracies, state elites have subjected consumers to their authoritarian economic sovereignty with the favoritism and abuse this always entails. Second, and more subtly, the system of economic governance devised around the principles of collectivist property rights and managerial one-man-rule encourages those in control to exploit co-owners[11], segments of the elite, the state and society, without the preventative checks of competitive markets and the rule of law. Third, state officials and managers often jointly conspire for the same purposes.

These moral hazards easily could be resolved by abandoning authoritarianism, and equitably distributing property rights in a generally competitive regime under the rule of law, or by retaining authoritarianism as a «second best» and subordinating those in control to the discipline of a civically responsible elite. The successes of American imperfect competition, Continental European corporatism and Soviet administrative command planning are suggestive in these regards. But neither solution has, or is likely to be adopted because elite interests and culturally determined impediments to stable consensus building make it extremely difficult to resurrect Soviet control, or move forward toward consumer sovereignty.

The special nature of Russia's dilemma can be appreciated more fully by setting aside various traditional concepts such as market and planning regimes, considering Russia's place in the hierarchy of contemporary economic systems illustrated in Figure 1. The apex is crowned in never-never-land by a class of supreme "social harmonist" systems in which every person is a motivated by non-conflicting desires to realize his or her material and human potential through harmonious interaction. This utopian class which includes Karl Marx's harmonian visions in the Grundrisse and Communist Manifesto begins with the premise that people's mental and physical powers are capable of discovering all that is discoverable, and optimally supplying all that can be supplied by eradicating sources of disharmony like private property. And it ends by inferring that if such systems are conceivable, they surely can be achieved.

Descending one rung, we encounter a closely related, but less ambitious class of ideal "economic harmonist" systems that restrict visions of harmonious optimization to work activities, without precluding the possibility that other aspects of social behavior might be disharmonious. If people cannot resolve all their conflicts, it is hypothesized that they can at least achieve their narrower economic potential by consenting to abide by appropriate social contracts. The best example of this class is universal perfect competition where all participants adhere to the golden rule. This competitive solution is utopian among other reasons because the appeal of the principle of fair play is insufficient to support the assumption that people will voluntarily subscribe to the golden rule, or honor their commitments. The same problem bedevils related ideological constructs where socialist, or communist consciousness, and the nationalization of the means of production aren't enough to assure perfectly planned economic outcomes.

Prudence and realism therefore have prompted economists and pragmatic so-

[11] Managers in Chinese state owned firms typically aren't co-owners, but they are in a position to sell assets and subcontract to private business which they or their relatives own. This makes Chinese state owned firms indirectly vulnerable to the same kind of moral hazard as their Russian counterparts.

cial philosophers to devise a third tier of systems, described in Table 1 as "economic dis-harmonism" by interpreting the premises of perfect economic models as working assumptions rather than as axioms. This allows theoretians to investigate the properties of idealistic constructs as they are loosely specified; to explore related requirements like the transitivity of individual preferences, or the possibilities of destabilizing dis-equilibria, and to examine how modifying one or more assumptions alters the results. These investigations have lead some to conclude that the theoretical potential of tier two utopian conceptualizations can be achieved within the restrictions of bounded rationality by building systems which closely conform with ideal premises, and that this goal has been largely accomplished in advanced market economies. Others see things differently, deducing for example that severe oligopolistic coercion, or macroeconomic destabilizing forces are endemic to market economies and have therefore constructed a fourth class of "economic dysfunctionalist" systems which exhibit numerous undesirable properties like stagnation and acute distributive inequality.

Scholars studying the laws implied by tier three and four concepts have considered every imaginable possibility. Keynes assumed that markets were nearly perfectly competitive, but vulnerable to mood shifts (and mis-expectations) in aggregate effective demand. Some have constructed mixed models with elements of perfect, and imperfect markets, government regulations and planning, while others have tried to identify dominant trans-systemic regularities. Macroeconomic and production function theorists routinely attribute depressions and aggregate productivity growth everywhere to factors like consumer confidence, and elasticities of factor substitution.

This proliferation of possibilities, where every aggregate model implicitly or explicitly is based on a different conceptualization of the workings of individual economies, or the entire global system has made it difficult to see the forest for the trees. Most modelers who implicitly view economics as a branch of engineering where plans and markets are interchangeable aren't really interested in identifying the primary motivational, mechanistic, and institutional forces shaping the entire array of economic outcomes. They are concerned with simple reduced form functional relationships that allow them to accurately forecast a few micro or macroeconomic dependent variables.

These goals aren't mutually exclusive. In an ideal fully specified model it should be possible to attribute every outcome to its causes, and ascertain why reduced forms provide accurate prediction. But the task isn't feasible, creating a natural fault line between economists who construct aggregate models on the assumption that most economies are ruled by the same engineering principles, and those who believe that motivations, mechanisms and institutions are diverse and matter.

This cleavage can be visualized by partitioning tiers three and four into two parts: category A where utility seeking everywhere leads to the same consumer sovereign results (including democratically approved welfare transfers), regardless of whether transactions are consummated through negotiation or assignment; and category B where ends and means differ from those of the individualistic competitive paradigm. The former is a-comparative (in the sense that outcomes are independent of mechanisms like markets and plans), and is usually thought of as purely economic. Its models are determined by technology, and technical parameters like supply and demand elasticities. The latter is comparative because potential and performance can be shown to depend not just on taste and technology (including asymmetric informational access), but distinct socially, politically and culturally sanctioned modes of utility seeking, and the mechanisms, institutions and moral hazards they entail.

Comparativists do not reject the methods or any specific principles of general theory. They merely take the position that a-comparativist economic models are often incompletely specified and misleading because they ignore demand side variables like culture, politics and ethics, and supply side mechanisms, institutions and moral hazards. These supplementary considerations shift the focus of systems models toward analyzing and assessing motivational, mechanical and institutional factors, and their impact on the comparative economic performance of individually, collectively, communally and authoritarianly organized systems.

Table 1.

ECONOMIC SYSTEMS: MAIN CONCEPTS

IDEAL

TIER 1

SOCIAL HARMONISM
DIVERSE UTOPIAS

TIER 2
ECONOMIC HARMONISM
PERFECT MARKETS

REAL

TIER 3 CATEGORY A (A-COMPARATIVE)	TIER 3 CATEGORY B (COMPARATIVE)
ECONOMIC DISHARMONISM	ECONOMIC DISHARMONISM
	1. MECHANISM 2. MOTIVATION a. political b. ethical c. cultural
TIER 4 CATEGORY A ECONOMIC DYSFUNCTIONALISM	TIER 4 CATEGORY B ECONOMIC DYSFUNCTIONALISM

The design of comparativist systems models is strongly affected by judgments about which motivations are preeminent, and the relative importance of demand and supply side influences. Three distinct tendencies are evident. Some comparativists reduce differences in potential and performance to mechanism; the degree to which various economies rely on markets, or plans. In doing so, they implicitly reject the notion that economics is a branch of engineering where the efficiency of markets and plans are the same. Some stress the primacy of motivation, while most are concerned with the interplay of motives and mechanisms. This subcategory has three important subtypes: political, ethical and cultural. Economic behavior in the first is determined by motives like authoritarianism and ideology; in the second by religious and secular codes of individual and group conduct. The cultural subtype is governed by complex values and social mores that modify and restrict individual utility seeking. Behavior in these models tends to be more heterogeneous than in a world dominated by generic ideologies, religious doctrines and political principles like socialism and authoritarianism.

The Russian economy today from the standpoint of this conceptualization is a tier 4 (dysfunctional) category B, authoritarian laissez-faire variant of the category A Langean socialist model[12]. It is distinguished by the authoritarian self-seeking of political, governmental and bureaucratic elites; majority state and worker ownership of substantial portions of the means of production; the "one-man-rule" of minority co-owner managers, and economic collusion among state officials, managers, the Red Mafia and oligarchs (a few tycoons who have cobbled together private financial empires from denationalized and semi-denationalized properties). The state, controlled by these elites claims proprietorship of the assets and incomes derived from the nation's mineral wealth, land and a significant portion of the medium and large scale capital stock, and additionally asserts the right to administer, tax, subsidize, price-fix, transfer, regulate and control any and all economic activities at its discretion. But neither Russia's political leaders, nor its governing bureaucracy has chosen to responsibly exercise these powers on the state's behalf. Instead they have withdrawn from the business of constructive micro and macroeconomic management, devolving autonomy to state appointed managers where majority ownership still is vested with the government, to co-shareholding managers in state minority owned assets, and to entrepreneurs in fully privately owned ventures without taking adequate measures to assure fair compensation, protect assets, and proprietary income. The state elites have embezzled state funds from the central bank, including IMF monies, pocketed money from the state budget, and participated in schemes for personal gain that would have been criminally prosecuted in the West.

This rogues gallery of politicians, officials, bureaucrats, oligarchs, managers, new entrepreneurs, security police, and professional criminals, many survivors of the Soviet Communist Party apparat collectively can be described as kleptocrats; a coterie that has usurped the economic sovereignty of the state, and consumers. They have created a byzantine set of property and market rights which reflect the ever changing, free form struggle within Russia to control the divestiture of the people's assets, and to institutionalize privilege. Private ownership in Russia is not the transparent, and familiar concept westerners often mis-suppose. Much of what passes for private property is actually semi-private, with various degrees of state participation, and non-state ownership dispersed among three groups: workers, managers and outsiders. Overall, the largest shareholders in the nation's assets are workers and the state, with proportions varying greatly both within and among classes of assets. The state is majority owner in a significant number of industrial and commercial enterprises, and nearly all of agriculture since it continues to own the land. Despite the

[12] Oskar Lange and Fred M. Taylor, On the Economic Theory of Socialism, University of Minnesota Press, 1938.

rhetoric of privatization, it retains a huge proprietary stake throughout the economy, which could easily allow the government to exercise operational control, especially if it dilutes the equity of other owners by arbitrarily issuing supplementary shares (velvet expropriation).

The public also has equity stakes in Russian firms as a result of a voucher scheme which gave each citizen a token share in the means of production. These shares were mostly deposited in mutual funds, partly embezzled and are now concentrated in relatively few hands, but they do not provide owners with assured dividends or influence. They may be important from time to time in acquisitions and various speculative ploys, but otherwise don't significantly affect enterprise operations[13)].

The smallest primary shareholding class is arguably management. The state granted this group approximately 20 percent of the insider stock, but through various means their share has risen to 15 percent of the total. The pattern of managerial ownership varies widely, seldom exceeding the combined weight of the state and workers, but managers nonetheless enjoy effective control thanks to legislation granting them one-man-rule, and the state's aversion to governmental micro-supervision. This decision replicates Soviet arrangements where worker collectives nominally co-managed production, but managers directed operations has brought about a radical separation of ownership and control, encouraging managers to pursue their personal interests at the expense of other co-owners through adverse selection.

The rationale behind Yeltsin's privatization strategy, insofar as he and his advisors understood its ramifications, and the dark motives of the klepto-elites, was much like Deng Xiaoping's. Both blamed the under performance of their command economies on the constraints placed by planners, and ministerial administrators on managerial discretion and entrepreneurship. These had been gradually relaxed since

---

[13] The initial book value of vouchers was approximately 50 dollars. A. Radygin, "Pereraspredelenie pravsobstvennosti v post-privatizatsionnoi Rossii,"(The Redistribution of Property Rights in Post-Privatized Russia), Voprosy ekonomiki, Vol.6,June 1999, pp.54-75 provides data on the evolution of insider and outsider shareholding for private corporations. According to the latest estimates by S. Aukutsionek, R. Kapliushnikov, and V. Zhukov, "Dominant Shareholders and Performance in Industrial Enterprises," The Russian Economic Barometer, 1998, No.1, pp.8-41 insiders held 58.5percent and outsiders excluding the state held 31.7 percent of industrial corporate shares in 1995. The state retained a 9.5 percent stake. Workers owned 48.5 percent of the total, directors 10 percent. Outsiders respectively held the following positions: banks 1.6percent, investment funds 7.2 percent, holding companies and FIGs 8.1percent, individuals 9.6 percent, foreigners 1.7 percent. Other accounted for 0.3 percent. The authors' forecast a decline in workers' ownership to 36.3 percent, and the state's share to 2.7 percent in1999 with the primary gainers being managers (15 percent), FIGs (11.8percent) and individuals(15.6percent). Separately, John Earle believes that there has been little change in ownership structure since 1994. Cf. John Earle and Saul Estrin, "After Voucher Privatization: The Structure of Corporate Ownership in Russian Manufacturing Industry,"paper prepared for the American Association for the Advancement of Slavic Studies meetings, Seattle, WA, November 22, 1997. Radygin concludes that the structure of ownership isn't as important as the corrupt control of managers. For a contrary view about the positive effects of privatization see Iu.Perevalov,, I. Grimadi, V. Dobrodei, "Vliiaet li privatizatsiia na deiatel'nost' predpriiatii? (Has Privatization Affected Enterprise Performance?), Voprosy ekonomiki, No.6, June 1999, pp.76-89.

Stalin's death, but it was believed that liberalization hadn't gone far enough, even under Gorbachev's program of radical economic reform. Managers were given restricted authority to modernize enterprise capital, redesign standard products and innovate new ones, vary product mixes, violate some plan targets, bonus maximize with respect to output and profit, market products outside the state material technical supply system, and start new ventures. But wages, prices, interest and foreign exchange rates remained fixed, and access to credit and money were tightly controlled. Enterprises for the most part did not sell their products for cash in the open market. They received credit entries in their accounts in the state bank as soon as non-defective goods were finished, and delivered to the state wholesale network, Gossnab. Wages and other input costs were debited in the same way. These practices deterred embezzlement, other misuse of state funds, and provided managers with the luxury of assured demand for whatever they produced. But they also tied managers hands, and subverted any possibility for competitive allocation of resources and product distribution.

Within weeks after the dissolution of the Soviet Union on December 21, 1991, urged by foreign advocates of shock therapy, Yeltsin attempted to free managers from these restraints, command planning, and ministerial supervision with one bold stroke. He canceled all non-essential state contracts, effectively terminating the principle of assured government purchase, and compelled enterprises to fend for themselves. To assist them in this task, firms were relieved of the burden of state bank financial controls, central plans, ministerial micro-production and distribution directives, and state fixed wage rates and prices. They were empowered to conduct their businesses with all the theoretical rights of category A transactors.

These included unfettered control rights over: 1) production, 2) pricing, 3) sales, 4) procurement, 5) foreign trade, 6) investment, 7) use of retained funds, 8) disposal of assets, 9) merger and acquisitions, 10) labor, 11) personnel management, 12) wages, 13) bonuses, and 14) internal organization and refusal to comply with illegal administrative edicts, or charges. These sweeping powers permitted Russian managers to act as if they were capitalist owners choosing location, facilities, and technologies; designing products, selecting least cost input suppliers, hiring and firing labor, negotiating wages, producing and distributing goods in assortments that maximize enterprise profits (for all shareholders including the state), and determining their own compensation. They were also permitted to form joint ventures with foreign corporations, and hold assets abroad.

Each of the 14 rights had the effect of relaxing a restriction on category A free competition, which other things equal should have, and in some instances surely did increase economic efficiency. As the newly fashioned state, semi-private, and private sectors began producing things people wanted at lower cost it seemed reasonable to suppose that the economy would build up considerable transformational momentum, attracting foreign investors lured by new opportunities and cheap, skilled labor. But these expectations weren't fulfilled. Instead Russia's economy began to sink like a stone, plunging simultaneously into hyper-depression (twice as deep as the American Great Depression of 1929), and hyperinflation (3,000 percent per annum) because the state hadn't prepared adequately for the transition, and the strategies it adopted, especially morally hazardous "semi-privatization," were destabilizing and destructive.

The most glaring initial defect of "shock therapy" lay in the impossibility of rapid transition from the command to the competitive model. Even if property somehow had been miraculously transferred into honest and competent hands in accordance with category A market principles, managers had no practical knowledge of redesigning products to suit consumer tastes, and effectively marketing their wares. Nor did they have access to credit to sustain current operations after the state withdrew from commercial banking. Managers found themselves in the hopeless position of producing goods the state as their primary customer no longer wished to buy, without adequate means of adjustment. But, Yeltsin's advisors miscalculations about the long term consequences of authoritarian laissez-faire were even more fatal. Western advisors and domestic liberals seemed to have believed that managers, in conjunction with the political leadership and the state bureaucracy would act in the collective interest as they debatably had during the Soviet period, despite the perverse incentives created by morally hazardous semi-privatization. This was a fundamental misreading of Russian culture by those who cared, and a cynical ploy for personal enrichment by those who didn't.

Socialists like Lange, and other moral idealists have often spoken as if they believed that collectivist trustees and minority co-owner-agents will always fulfill their duties. In the Russian case, where guilt culture predominates over shame this means that Christian, socialist, or rationalist idealism must inspire leaders, managers, workers, peasants and outside shareholders to exert themselves, and take initiative in a disciplined manner. The evidence is disheartening. Although, Russians everywhere display admirable intelligence and vitality, with compassion for relatives, friends and strangers, this hasn't been enough to overcome the moral hazards of authoritarian laissez-faire in minority co-owning, manager controlled, state unsupervised firms. Nor has it deterred klepto misgovernment and collusive state elite-managerial rent seeking. Russia had difficulty with corruption and disorder even when ownership and control were relatively unified under the Bolsheviks and the Czars, when communist idealism and Christian virtue were significant moral influences. Prospects today when the klepto elites and managers have been given carte blanche, and idealism is in decline isn’t promising, despite Russia's enormous development potential.

It is therefore reasonable to infer that Russia's "authoritarian laissez-faire" where politicians and state officials primarily use the proprietary, regulatory and delegatory powers of the state to further personal ends, contemptuous of their civic responsibilities, colluding with managers for their own benefit at the expense of other shareholders including the state, will not operate strictly according to the morally hazardless, individual utility seeking principles of the western category A competitive paradigm. The motivations, mechanisms and institutions that govern demand, supply and equilibration all differ importantly from those assumed in the classical tradition, creating a system where the state elites rather than individual consumers are sovereign. Their preferences at all levels of society prevail defining the sense in which the Russian system is micro and macroeconomically controlled. The phenomenon can be conceptualized as two tier system where those with privileged access to the state including favored managers, provincial authorities and the Red Mafia are in a position to prosper disproportionately, while managers of valueless assets, workers, peasants, and small proprietors are obliged to fend for themselves in an intensely adverse environment.

The mechanisms employed to realize these objectives are consistent with authoritarian motivation. The elites have learned through experience that the Stalinist command model, Brezhnev's cautious reformism and Gorbachev's iconoclastic radicalism don't deliver the material benefits desired. They are chary of each other, honest managers, entrepreneurs, workers, peasants and foreigners. The state elites therefore have retained those elements of authoritarian power including state contracting, finance, and regulation which further their purposes, coupling this with property and market rights which allow them at all levels to "legally" exert authority incompatible with the requirements of category A individualist competitive models, harnessing markets for what in category A systems are corrupt ends.

The same principle applies to institutions; that is, the organizations and procedures governing market, administrative, planning, and criminal activities. Semi-privatization, worker ownership, the separation of majority shareholder ownership from managerial control, kleptocratic economic governance, and the absence of the rule of law are specific institutional aspects of the authoritarian laissez-faire mechanisms Russia's leaders approve.

The operational consequences of these motives, mechanisms and institutions are best understood with respect to the competitive category A standard. As with most systems, the transfer of economic sovereignty from individual consumers to other entities doesn't obviate the laws of demand, supply and equilibration. Selected alternations are enough to noticeably affect performance characteristics and potential. Individual Russians in their roles as consumers conduct themselves on the surface like everyone else. They form preferences. Their demand appears to be an inverse function of price, given their budget constraints. The assortments they purchase are sensitive to relative prices. Their preferences appear to be consistent, and they try to minimize the cost of the market baskets they select. But their consumption and employment behavior departs from the efficiency standard because individual utility seeking is distorted by forced substitution. Household demand for public collective goods is mostly disregarded, and consumers are compelled to purchase items the system supplies, not those they desire. Likewise, Russia's devitalizing authoritarian laissez-faire prevents workers from finding preferred employment and earning the full incomes they would under perfect competition.

The situation with respect to the law of supply is similar. The technologies of nearly all Russian firms exhibit diminishing marginal productivity and increasing marginal cost throughout stage II. Individuals and businesses fully understand that they can augment their utility by trading with others, offering their labor, creating value added, starting entrepreneurial ventures, innovating, hiring factors, economizing costs, improving technology, product design and financing, touting the their products, and effectively marketing them. They grasp the merit of efficient administration, and planning. But they are often compelled to disregard the law of labor and product supply because of the disruptions caused by state elite micro and macroeconomic mis-intervention, and enterprise moral hazard games that distort production, distribution, and effort. Derived labor demand therefore is only a weak function of wages, and a stronger function of authoritarian laissez-faire. Derived demand for outside management recruits is increasingly a function of compensation, but is also distorted by insider management rent seeking. Just as in the case of egalitarian labor managed firms, insiders may suboptimally hire additional managers if they feel obliged to share asset rents with them. Managerial supply curves are increasingly functions of compensation, but are also strongly distorted by anti-productive co-owner self-seeking.

Russians don't profit maximize in the sense required by category A competitive systems because the separation of majority shareholder ownership from minority co-owner managerial control; official collusion with managers, and other arbitrary forms of government intervention discourage managers from maximizing returns to shareholder equity. To be sure some Russian managers and businessmen pioneer new ventures, innovate, invest in research, development, testing and evaluation (RDT&E), hire and train promising personnel, carefully select technologies, modernize, economize variable input costs including finance and advertising, conduct market research, set prices and sell their products to earn sufficient revenue. But none of these activities are carried out solely to maximize the stream of shareholder dividends and derivatively returns to the people. Business isn't just a device allowing utility seeking individuals to optimize lifetime consumption, including leisure detached from the personal and civic agendas of klepto-officialdom, and moral hazard. It is a control process through which the state-elites pursue their sovereign objectives. Entrepreneurial ambition, innovation, and modernization is tempered by the predatory practices of envious officials and the Red Mafia. RDT&E, corporate growth, employment, and labor mobility are unduly encouraged or discouraged as authoritarian-politics dictates. Enormous amounts of time are squandered working to rule in conflict ridden, semi-privatize firms where Soviet era attitudes continue to prevail in an environment of anti-productive corruption. Adversarial semi-privatized insider shareholding also feeds resentments and instills effort reserving attitudes among workers who cannot help recognizing that despite the state's solicitude in making them shareholders, they have been stripped of the social protections they previously enjoyed, and their value added is severely under-rewarded.

All these infringements of category A laws of demand and supply affect the possibilities, characteristics and processes of equilibration. The Walrasian, Marshallian and Keynesian adjustment mechanisms in individualistically organized economies all seek to reconcile the demand and supply programs of each and every person so that everyone is optimally satisfied (including holdings of idle cash balances), given budget constraints at competitively negotiated prices. Russian authoritarian laissez-faire precludes this possibility by forced substituting the choices of the state-elites for some individual demand and supply programs, and by encouraging official and managerial collusion as surrogates for competitive negotiations. Political leaders, officials, minority co-owners of all types, state functionaries, small private venturers, workers, peasants and the Red Mafia are able to reach agreements, but the equilibria achieved don't optimize individualistic, or collectivist welfare because the terms of demand and supply aren't fully and fairly negotiated with respect to internal elite preferences, or external opportunities. Equilibria are necessarily second best from all perspectives, and depend significantly on the vagaries of power and corruption.

Another way to look at the same phenomenon is to recognize that the Russian economic system has five distinct market equilibration mechanisms; the familiar Walrasian, Marshallian and Keynesian trio, plus state elite economic mis-governance, and morally hazardous minority co-owner self-seeking. Kleptocratic machinations sacrifice competitive efficiency and the state's power agenda for mercenary gain and privilege, while minority co-owner conniving subverts productivity and national welfare. The Walrasian mechanism is impaired because selected price-fixing and other collusive practices impede or forestall the equilibration of deficits and surpluses in factor and inventory markets.

The Marshallian adjustment mechanism which in category A systems depends on profit maximizing responses to factor and output prices to achieve and sustain equilibrium is similarly disordered because managers subordinate profit maximizing to other goals, including asset-stripping (spinning off valuable assets to themselves), and asset-grabbing (using illegal means to dilute other shareholders assets, and to seize properties of other companies). And of course, kleptocratic politicians, officials and bureaucrats warp market discipline with sundry controls, discriminatory taxes, and regulations including price, wage and foreign exchange rate manipulation, and foreign capital controls. Russian firms can and do respond to outside demand, but supplies cannot correspond to a full utility maximizing equilibrium either for outsiders, or members of the elite because of elite mis-governance and corruption.

The impact of authoritarian laissez-faire on Keynesian processes is also aberrant. The misdirected actions of the state elite and managers have disordered the linkage between consumer demand driven by personal disposable income, and managerial supply responses. In the Keynesian model domestic consumer goods manufactures increase and decrease their activities as personal disposable income fluctuates, with investment oscillating with the state of business confidence. But Russian manufacturers have shown themselves either unable or unwilling to act accordingly because they lack credit for operations, are excluded by importer control of retail outlets, cannot produce desirable goods, or are otherwise absorbed with non-productive strategems. The adversarial and predatory business environment also drastically depresses the marginal efficiency of investment, and increases speculative demand for idle cash balances, preferably in the form of hard currency deposited abroad, which together severely repress aggregate effective demand, creating conditions of persistent hyper-depression that have been the hallmark of Russian authoritarian laissez-faire. And of course these problems are compounded by irresponsible monetary and fiscal policies intended solely as devices for robbing the treasury, and abetting speculative financial games. For example in the early nineties Yeltsin was in the habit of ordering the treasury to print money without collateralization, and then distributing it as he saw fit. The nature of these macroeconomic destabilizing games is volatile. In the mid-nineties, money emission was tied to the sale of government bonds; a strategy which reduced inflation, but then lead to the government simply defaulting on its debts in August 1998[14).]

All of these diverse distortions are reflected in Russia's sub-systemic economic structure and its special performance characteristics. The heart of the Russian economy is its «closed» state elite network which prospers from the sale of the nation's natural resources, and sundry forms of rent-seeking, asset-stripping and asset-grabbing behavior including defrauding foreign investors and assistance-givers like the International Monetary Fund, the World Bank and the European Bank for Reconstruction and Development (acknowledged, and then later denied by the former American Secretary of the Treasury, Robert Rubin). It has two components. The first is the traditional Soviet-type public sector which provides basic military, security, health, education, administrative and regulatory mis-services, together with the

---

[14)] Review and Outlook, «The Russia Racket,» Wall Street Journal, March 31, 1999, p. A22. Alan Cullison, "Vanishing Act: Share Shuffling Saps Oil Giant Yukos Nearly Dry, Wall Street Journal, July 15, 1999(electronic).

foreign sale of natural resources and weapons. The second is the transfigured Soviet state industrial, commercial and agricultural sector, divided into a small cluster of favored enterprises, and a large group of disregarded bankrupt firms. The productivity of both components is extremely low, disguised in the eyes of some by the opulent life-style of those living lavishly off the system. It relies for the most part on anti-competitive methods of all sorts that are incompatible with category A models, and destructive to present and future national economic welfare.

Russia of course has no perfectly competitive markets, and the productivity and prospects of most private mom and pop operations seems grim, even though many see these small venturers as the avant-garde of an emerging category A capitalist market revolution. The outlook for the Red Mafia is brighter. They are a ruthless group of violent criminals, many hardened in Gulag, who provide the usual assortment of dis-services including prostitution, gambling, narcotics, entertainment, extortion, and murder on an extraordinary scale. They prey on all vulnerable citizens and companies that have revenues and assets worth protecting, and are actively involved in banking, the upscale hotel, luxury goods trade and in the subjugation of illegal residents. However their affluence is hardly evidence of a bright future for Russia's authoritarian laissez-faire system. It is just another indication of its plight.

The power and purposes of the state-elite, the corrupt activities of managers and the complementary compellent methods employed by the Red Mafia thus explain the preponderant part of the performance characteristics of Russian subsystems; the stability of its structures, and the unique aspects of interactions. In individualistically organized category A systems, markets of varying efficiency are equilibrated through Walrasian, Marshallian and Keynesian mechanisms, state activities and criminal compulsion. But in Russia economic activity throughout is designed to facilitate and complement the state-elites' personal and political objectives. Businesses, the state bureaucracy, small private proprietorships, and criminal organizations are all enmeshed in Russia's fourth and fifth ways; economy wide webs of elite domination.

The main effects of Russia's authoritarian laissez-faire are evident. It has created an extremely demobilized, work suppressing, klepto-elite dominated, macroeconomically hyper-depressed and destabilized, corrupt, inegalitarian, minority coowner collusive market system with a low standard of living[15]), and destructive, elite

[15]) Iu. Ivanov, "O mezhudunarodnykh sopostavlenniiakh VVP," (On International Comparisons of GDP), Voprosy ekonomiki, No.3, March1999, pp.112-127 argues that dollar purchasing power parities"experimentally" derived according to methods employed in a 1996 OECD study indicate that Russia's per capita GDP in 1996 is 27 percent of the U.S. figure. This estimate is 35 percent greater than the figure derived in a Goskomstat RF study, undertaken in conjunction with the OECD in 1993, and places Russia in tier 3, the mid range of the United Nation's five tier development classification. Alternative estimates for 1995 by Aleksei Ponomarov, Deputy Chief of the Department of National Accounts,(Goskomstat RF) presented in 1998 based on regional data place per capita GDP at about 58 percent of Ivanov's estimate, implying a standard of living in tier 4(underdeveloped), in the vicinity of Thailand. All these various estimates can be instructively compared to the CIA's and Goskomstat SSSR estimates circa 1991 which placed Russia(not the Soviet Union) in the tier 1 with a per capital income of 13,137 dollars in 1991 prices. Obviously, results depend on the underlying conventions used to form purchasing power parities. If a "composite good" cost

tolerated organized crime. Insofar as the various segments of society are satisfied with these arrangements, the model could endure for decades. But few observers believe that authoritarian laissez-faire will survive in its current form. The klepto-elites, co-owner-agents, oligarchs, provincial potentates, and the Red Mafia want their positions enhanced through the consolidation of their entitlements and privileges under a suitably supportive, klepto-friendly rule of law. There is ample precedence for this in Russia's Czarist past, where the nobility found it convenient to subjugate most of the population, living unproductively off the nation's resources and oppressed labor. But Russian liberals, the emergent middle class and segments of the working class and peasants desire greater economic opportunity and security. The lure of prosperity inclines them toward category A markets systems, their insecurities toward a better forms of authoritarianism, perhaps like China's where the Communist Party has done a better job disciplining segments of the state elite and restraining managerial rent seeking and adverse selection[16].

The Geometry of Russian Authoritarian-Laissez-Faire

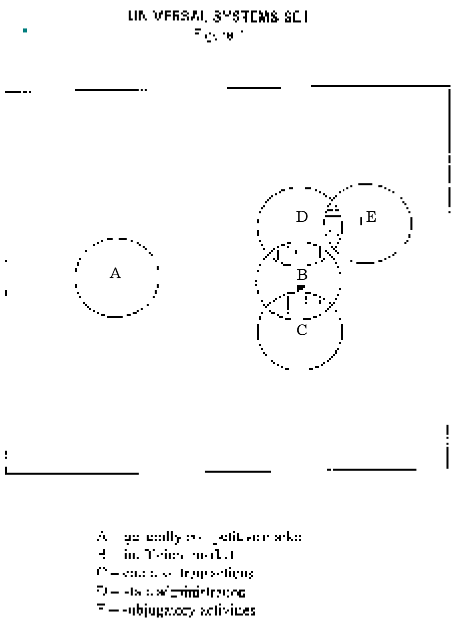
To better appreciate these special traits, and the broader inefficiencies of authoritarian laissez-faire, let us re-examine these matters geometrically starting with the concept that systems are composites of various subsystems. The universal set of economic activities, which includes various kinds of market and non-market mechanisms contains five basic subsystems: (A) generally competitive markets for some generic products, (B) inefficient markets caused by incomplete profit and utility maximizing, (C) anti-competitive markets, (D) state administrative bureaucracies which mis (regulate) and mis (command), (E) oppressive activities where some compel others to do things against their will. These subsystems which encompass voluntary, coerced, regulated, and compulsory exchange are illustrated in Figure 1, the universal set of economic activities. The blank spaces separating the subsets, refer to leisure activities excluded from conventional definitions of gross domestic product

basis(including cost estimating relationship and engineering studies) is employed in line with CIA practice, then the quality of Russia's exportables and non-tradeables is usually significantly overstated, as is their global market worth. Contrary to Ivanov's assertion, Russia's unfavorable exchange rate confirms the low international value of its non-natural resource exportables, and its low standard of living judged in terms of global preferences. The ruble is not 58 percent undervalued as he suggests. See Aleksei Ponomarenko, "Gross Regional Product for Russian Regions: Compilation Methods and Preliminary Results," Conference on "Regions: A Prism to View the Slavic-Eurasian World," Slavic Research Center, Hokkaido University, Sapporo, Japan, July 22-24, 1998. CIA, Handbook of International Economic Statistics,CPAS92-10005, September 1992. Steven Rosefielde, "Unlocking Northeast Asia's Development Potential: The Russian Paradox, in Kimitaka Matsuzato, Regions: A Prism to View the Slavic World, Slavic Research Center, Hokkaido University, forthcoming 1999.

[16] The Chinese have avoided minority co-ownership while semi-privatizing in part by selling shares in some otherwise wholly owned state enterprises in the open market. Until now, enterprises have listed just 20 percent to 30 percent of their shares, insulating managers from market pressures. The Communist Party is now considering allowing more than 50 percent of shares to be listed, but leaving the state as the largest shareholder. Ian Johnson, China's Leaders Meet for Annual Strategy Session, *Wall Street Journal*, July 27, 1999, p. A19.

like hugs and kisses.

Only the perfectly competitive subsystem, conspicuous by its absence in post-Soviet Russia is consistent with the axiomatics of market efficiency. It is micro and macroeconomically self-regulating. The behavioral characteristics of the other subsystems are less predictable. Profit and utility maximizing may be incomplete in varying degrees for a host of reasons that depend more on context than universal principle. The same is true for monopoly, oligopoly, oligopolistic competition and criminal extortion, which compel victims to accept disadvantageous terms of exchange up to the point where they voluntarily switch to near substitutes[17]. Subjugation ranging from criminal compulsion to slavery allows masters to impose their will on those they control no matter how onerous the terms of exchange[18]. And of course while it is possible to imagine an efficient bureaucracy, there are no automatic mechanisms disciplining the state to attentively respond to its clients needs, or to cost effectively provide services[19].



Economists influenced by the theory of the second best, believing that all major economies today are governed by imperfectly efficient markets (B), are inclined to infer that the comparative performance potentials of diverse market systems are broadly alike, paying scant attention to the rest of the universal economic activities set. They assume that B, or the union A U B is the universal set, and discount the repressive influence coercive market power (C), state bureaucracy (D), and subjugatory activities (E) have on free markets. These attitudes cause them to disregard the obvious heterogeneity of predominantly market systems, and the role diversity plays together with technical failures and policy errors in explaining observed behavior.

Coercive market power not only distorts distribution, it diminishes factor effort, productivity and market size. State bureaucratic mis-regulation has similar effects, which may be aggravated by prohibitive commands restricting entry and

---

17) Market transactions are defined as voluntary exchanges. Any transactions in which one party must «take it» and cannot «leave it»; that is, where preferred substitution is forcibly prevented is involuntary, and hence cannot be considered the outcome of a market process. It is compellent, or directive.

18) The term subjugation is interpreted broadly to cover a wide range of compellent actions including edicts, directives, assignments, orders, commands, binding obligations in the factor, production, financial, and distribution sectors.

19) Private and governmental coercion(regulation) and subjugation(directives) are conceptually identical, differing only with respect to the degree to which state authority is assumed to be socially legitimate.

dampening competition. Tariffs, quotas, non-market barriers, state licenses, cronyist contracting are just a few of the ways that this is accomplished. And private subjugatory actions may be even more dysfunctional. Mafia harassment of workers and managers, denial of credit by importer controlled banks to import substituting domestic industry and other such practices shrink production potential, and diminish social welfare further through the proliferation of criminal disservices like prostitution and drug trafficking.

These effects can be visualized by varying the size of the subsystems sets and observing their intersections. Russia is distinguished by its null perfectly competitive sector, and its small imperfectly efficient market (B) which is partly dominated by coercive market power (C ∩ B), and crony influenced bureaucratic regulation (D ∩ B). It has a large mis-administrated state sector which controls portions of the industrial capital stock, together with nearly all land and resources (D), and colludes with minority co-owner managers for personal gain (D ∩ C). And it has a vast crime intensive subjugatory sector (E) [20]. This configuration of the economic activity space, epitomized by the compressed and coerced state of Russia's inefficient market (B, C), and its bloated directive subsystems (D, E) illustrate why the economy is under-productive even before taking account of technical and policy issues like obsolescence, capital infungibility, enterprise arrears, and shock therapy[21].

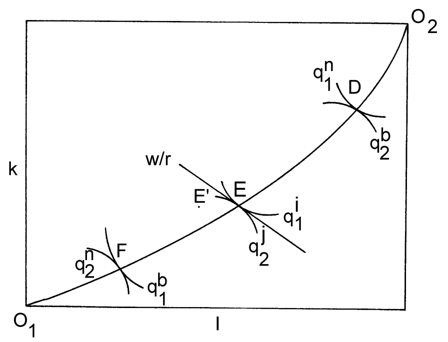


Figure 2

But the size and configuration of subsystems are only part of the story. Under-productivity is aggravated by the interaction of Russia's subsystems. Authoritarian laissez-faire inefficiency in each subsystem constrains the potential of the others, while mistrust prods defensive misconduct (kto kovo?).

These principles can be clarified further by examining the ways in which profit sub-maximizing, and ethically undisciplined utility maximizing, cause the Russian market to deviate from the classical efficiency ideal[22], with the aid of Edgeworth-Bowley production and consumption boxes, and diagrams depicting production possibilities and community indifference curves. As is generally understood, the functions considered here, and the associated equilibria can be realized theoretically either through perfect competition, or perfect simulated planning. Supply side rela-

[20] These phenomena are described variously in the literature. See Anders Aslund. «Rentoorienntirovnnoe povedenie v Rossiiskoi perekhodnoe ekonomike (Rent-seeking Behavior in Russia's Transition Economy), «*Voprosy ekonomiki*, Vol. 8, 1996, pp. 99-108. Anders Aslund, «Russian Banking: Crisis or Rent-Seeking?» *Post-Soviet Geography and Economics*, Vol. 37, No.8, 1996, pp. 495-502.

[21] Steven Rosefielde, "Russia's Economic Recovery Potential: Optimizing the Residual Productivity of the Soviet Capital Stock,"*Comparative Economic Studies* Vol.36, No.4. Winter, 1994, pp.119-142.

[22] Bureaucratic, coercive and subjugatory economic activities conducted in the nonmarket complements of subsystems sets C,D,E also contribute to GDP, but are not treated here explicitly. It is assumed that they diminish welfare.

tionships shown in the Edgeworth-Bowley production box, Figure 2, and the production frontier spaces, Figures 3 and 4 take two forms, deviations along the contract curve away from the generally competitive equilibrium (E), and points off this locus. The Edgeworth-Bowley production box shows the geometric relationships between primary factors of production (capital, k and labor l) along the sides of the box; and the isoquants of firms producing two different goods (q_1 and q_2) radiating in increasing order from their respective origins. The locus of joint tangencies of these isoquants represents Pareto efficient allocations and employments of capital and labor, given the wage-rental ratio, and the output price ratios which would hold if the product and input mixes were optimally responsive to different configurations of competitive demand. This nuance is important because it defines the sense in which every point along the production possibilities frontier is consistent with a "golden rule abiding" rivalrous, competitive efficiency equilibrium. If other input and output prices were utilized, different frontiers could be generated, but they wouldn’t be generally competitive.

Deviations from the general competitive equilibrium point E on the contract curve thus have very specific meanings. They imply that market participants may be occasionally inadvertently demand a sub-optimal product mix, but otherwise maximize profits and utility in all four core markets. This type of distortion is depicted in Figure 3 as a movement either to the left or right of the universal equilibrium point E along the production possibilities frontier, and is often described as "economic" inefficiency rather than a "technical" shortcoming because while demand isn't optimized, supply is "technically" efficient.

All other lapses of competitive discipline including violations of antitrust law, subjugation and bureaucratic mis-administration degrade supply efficiency, and consequently necessitate production beneath the production possibilities frontier in Figure 3. If these inefficiencies proportionally diminish product quality, or the factor productivity of both products, the assortment of goods and services will be the same as that of a generally competitive equilibrium (assuming demand is efficient), but the amounts produced and distributed will be reduced. The set of all such points v is illustrated in Figure 4 as a ray (expansion path) lying between the origin and point E, and corresponds in the Edgeworth Bowley production box with a downward renumbering of the isoquants (and a contraction of the box). The larger the numerical reduction in isoquant values, the steeper the shortfall from the production possibilities frontier, and of course any violation of the double tangency requirement may constitute a further proportionate decrease in supply. Just as the points along the production possibility frontier other than E in Figure 3 are "technically" efficient with respect to supply, the points along the expansion path n in Figure 4 can be described as "economically" efficient with respect to the desired universal equilibrium assortment, although the term economic effi-

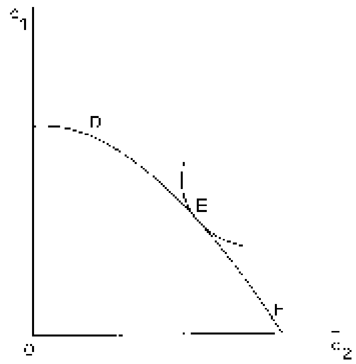


Figure 3

ciency sometimes is reserved solely for point E.

All other inefficiencies which involve both demand and supply whether stemming from incomplete individual sense, search, evaluation and negotiation, or from the assertion of market power will push production off the contract curve in Figure 2, and off expansion path v between the origin and point E in Figure 4 to v', implying that the economy is both technically and economically inefficient. This is conventionally illustrated in Figure 4 by point E" which lies on a "production feasibility frontier" constructed analogously with the production possibilities frontier, subject however to a set of explicit constraints.

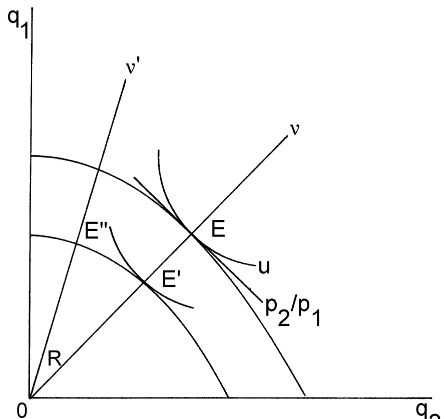


Figure 4

The degree of inefficiency for any particular case, given these concepts can be gleaned by considering all supply side lapses in competitive discipline. Starting with factors, any lapse which distorts judgment, effort and input service time, or external coercion may cause capital and labor (including management) to be mis-supplied and mis-allocated. Laziness and business pessimism may reduce voluntary input supply, and inflict involuntary factor unemployment. Or in euphoric periods, people may voluntarily overexert themselves, or be pressured into working overtime. In either case, the size of the Edgeworth-Bowley production box may shrink or expand, and isoquants may be reordered (due to under or overexertion) [23]. Aggregate economic activity in the production space will be sub-optimal regardless of whether factors are being under or over utilized. Any input mis-allocation for example due to excessive union pay scales, will further degrade productivity and welfare, as will mis-education and mis-training where growth is a matter of further concern.

The degree of state approved distortion in the Russian authoritarian laissez-faire factor space is extraordinary. The supply of both capital and labor are depressed and mis-allocated by co-owner moral hazard (given managerial one-man-rule), subjugation and related government restrictions. This means that managerial insiders who control these assets have no pecuniary incentive to maximize shareholder profits from current operations, or the present discounted value of the capital stock through other means including investment. They are inclined instead toward asset-stripping, rent-seeking and anti-competitive collusion. During the Soviet period corresponding inefficiencies were partly mitigated by state ownership, mandated managerial bonuses and centralized procurement of capital durables, but insiders now are left to their own devices. As a consequence the size of the Edgeworth-Bowley production box has drastically contracted. Approximately 70 percent of the industrial capital capacity is idle (judged by prior achieved production levels during the Soviet era) and labor unemployment (including under and mis-employment) is in the high double digits.

[23] One of the principal functions of management is preventing avoidable under-exertion.

The isoquant levels within the production space also have been reduced because capital and labor are mis-incentived and inadequately rewarded. And of course, factor prices are in acute disequilibrium due partly to entry barriers and economic disorder. It has been variously estimated by Valerii Makarov and Georgii Kleiner that more than 70 percent of all intermediate inputs are bartered at diverse terms of trade in the industrial wholesale market[24]. Thus instead of operating at E" on the normal imperfectly competitive production feasible frontier illustrated in Figure 4, production actually occurs on a drastically lower feasibility frontier at point R.

Moving upstream to the product market, attention shifts to product characteristics, technology and competitive profit maximizing. A nation cannot realize its full competitive potential unless it produces goods with the right characteristics. The qualitative aspects of q_1 and q_2 must be ideal from the standpoint of equilibrium demand. Misjudgment, irrationality, and market power could all cause severe supply inefficiencies. In the extreme, outputs may turn out to be "bads" instead of "goods," and so unsaleable. Such losses can be illustrated by converting inferior goods into smaller quantities of superior outputs at the equilibrium marginal rate of transformation, and renumbering isoquants accordingly. The same kind of adjustment is required when the technologies embodied in isoquants do not reflect the optimal rate of introduction of best practice techniques[25].

Likewise, when managers fail to optimally organize and incentivize their enterprises, and entrepreneurs do not capture rents and pioneer new ventures as fully as they should, realized output is below potential necessitating a lowering of the isoquant values in the Edgeworth-Bowley production box, and an inward shift off the production possibilities frontier[26].

Production inefficiencies in one or both activities may also occur if firms incompletely profit maximize by failing to acquire inputs at least competitive cost, or hire them to the point where marginal cost equals price. And of course, proprietors who illegally exert market power by restricting output, or engage in other anticompetitive practices that enlarge market niches, and artificially create economic rents drive production off the Edgeworth-Bowley contract curve to points on production feasibility frontiers that are inefficient from the perspective of both supply and demand[27].

---

[24] Personal conversation with Valerii Makarov January 4, 1999. Cf. V.I. Makarov and G.B. Kleiner, «Barter v Rossiiskoi ekonomike: osobennosti i tendentsii perekhodnovo perioda," Tsentral'nyi ekonomiko-matematicheskii institut, preprint, WP/96/006, Moscow 1996.V. Makarov, and G. Kleiner, "Barter v Rossii: institutsional'nyi etap,"(Barter in Russia: Institutional Stage), Voprosy ekonomiki, No.4, April 1999, pp.79-101. A. Iakovlev, "Prichinakh bartera, neplatezhei i ukloneniia ot nalogov v rossiiskoi ekonomike,"(On Reasons for Barter, Arrears and Tax Evasion in the Russian Economy), Voprosy ekonomiki, No.4, April 1999, pp.102-116.

[25] The technologies embodied in the fixed capital stock cannot be drastically altered in the short run. The only aspect of technology therefore that bears on efficiency is the degree to which technological improvements correspond with the competitive optimum.

[26] Although all individuals in the generally competitive model independently maximize their utility, managers are permitted to non-coercively negotiate conditions of employment and organizational matters with their employees which may profoundly affect enterprise productivity.

[27] In the real world markets are often segmented in the sense that the same product will be sold at different prices in various locales. Discount stores routinely underprice their

Yeltsin's authoritarian laissez-faire is afflicted with all these ills. Most products were designed in the Soviet period when consumer preferences were disregarded, and are virtually unsaleable in the global marketplace. The relaxation of state standards, and lax enforcement has resulted in widespread product adulteration, while the introduction of improved products is modest, with the exception of new service sector construction, and housing for the elite based on foreign designs and often built under the supervision of western contractors. These failures are partly attributable to state ownership and the contradictions of Russian industrial and agrarian collectivist property rights. Managerial insiders in state owned enterprises frequently don't care what they produce, while workers and collective farmers are preoccupied with other concerns. Inattentiveness to product characteristics is also explained by elite preference for foreign goods, and the lack of capital to finance redesign and innovation.

These same forces degrade productivity, and output supply. Most firms and farms in Russia profit sub-maximize. State enterprise managers, managers of semi-privatized firms, and collective farmers have little reason to minimize cost, or produce to the point where marginal cost equals marginal revenue (or price when they are price-takers). Derived demand for inputs consequently is deficient and misdirected, and enterprise organization is inefficient[28]. Some firms however have prospered. But unfortunately most of these cases are exceptions that prove the rule. The surest path to riches in Yeltsin's Russia comes from asset-grabbing (unjust acquisition of state property by misappropriation, looting, and underpayment); asset-stripping (state sanctioned divestiture, scrapping and sale of otherwise useful collectively owned assets for personal gain), and rent-seeking (securing non-competitive government contracts, and market restricting regulations to obtain unearned income and excess profits). The beneficiaries of these practices including various large banks (some controlled by the Mafia), the conglomerates assembled by Russia's tycoons, and natural resource processors beholden to state officials owe their good fortune entirely to collusion and coercion in restraint of trade, and governmental abuse. They are contemptuous of textbook profit maximization, and cause enormous material harm by squandering resources and repressing competition.

All these sources of productive inefficiency might warrant only passing concern, if entrepreneurship were ebullient. Schumpeterian theoretists often suggest that every inefficiency provides profit opportunities for wealth creating entrepreneurs. Russia consequently should be a gold mine for industrial venture capitalists. But it has proven instead to be a wasteland because the state, tycoons, and Mafia always seem to find ways of appropriating entrepreneurial profits and assets. As a consequence, Russia's productive efficiency is wretchedly low, judged from either the competitive ideal, or western imperfectly competitive standards. Its primary real substantial source of non-illusory income comes from the sale of natural resources.

Laxness and malfeasance in financial markets by lenders, investors, speculators and governmental regulatory agencies may significantly compound factor and

---

full service competitors. Insofar as such differentials are justified by the cost of delivering different levels of shopping experience, they are compatible with competitive principle, but often the price differential is disproportionate because of "velvet" coercion in the form of deceptive advertising and other malpractices.

[28] Eyewitness reports from Lockheed's satellite rocket joint venture in Moscow confirm that the facility was grossly overstaffed, and under-motivated.

managerial inefficiencies. If governments mis-regulate credit, interest and foreign exchange rates; bankers exercise unusually poor judgment in evaluating credit risks, and investors and speculators under or over-borrow, the economy may become macroeconomically depressed, or overheated. Contractions and excessive expansions of the Edgeworth-Bowley production box may be exacerbated, isoquant levels diminished or augmented in ways that reduce utility, and factor mis-allocation and product mis-assortment intensified. These distortions may be persistent, or cyclical generating the familiar boom-bust pattern characterized by intermittent periods of over and under full employment, under and overinvestment, inflation and deflation, prosperity and depression. Supply in all these various ways may be gravely inefficient, even in the absence of government sanctioned economic misconduct.

The collapse of Russia's financial system in August/September 1998 speaks for itself. The state, and favored private banks have been up to their ears in one financial fraud or another from the outset[29]. During the first two years after Yeltsin came to power on December 21, 1991, the government resorted to un-collateralized currency printing to pay its bills, wiping out the personal savings of ordinary people and diverting vast sums to the elites[30]. This was then followed by a new scam in which banking became primarily a business of lending overnight deposits to the government at above competitive rates instead of making productive loans to commerce and industry. The government covered these disguised transfers by floating dollar denominated paper in the west at rates in the vicinity of 100 percent per annum that could not be sustained, leading directly to default and the subsequent collapse of the entire financial system. Although, some of these tactics have been applauded for curbing inflation, Russia's financial sector obviously is a fiasco. The government and its cronies not only mismanaged the supply of credit, and the allocation of loanable funds starving traditional industrial enterprises for operating capital, but dysfunctionally manipulated interest and foreign exchange rates compounding the nation's under-productivity and inefficiency.

Any supply side inefficiency, large or small must degrade social welfare because the community will have fewer goods and services than it could have enjoyed, often with the wrong characteristics, in dis-preferred assortments. Matters moreover may be worse if product demand is partly ineffective, and the distribution of outputs is inefficient and inequitable. Again, lapses can be ascribed to two distinct causes in the competitive paradigm: inadvertence and moral hazard. Their consequences can be highlighted with the aid of community indifference curves overlaid on the production frontier space in Figure 5, the Edgeworth-Bowley consumption box illustrated in Figure 6, and the social utility frontiers in Figure 7.

[29] During 1997 the state owned Russian Central Bank(CBR) earned about 3 billion dollars from trade in high yield government securities, but only 250 million dollars was transferred to the budget. The rest was "misappropriated." See Vladimir Ivanov, "Crisis in Russia: As Bad As It Gets," ERINA REPORT, Vol.25, December 1998, p.28. The Central Bank is now under investigation for embezzling an additional billion dollars.

[30] Steven Rosefielde, "Klepto-banking: Systemic Sources of Russia's Failed Industrial Recovery," in Howard Stein, ed., *The Nigerian Banking Crisis in Comparative Perspective*, Macmillan, New York, forthcoming, 1999.

Recalling that the universal competitive optimum is depicted by the joint tangency of the community indifference curve and the production possibilities frontier at point E in Figure 5, aggregate demand side inefficiency can be described as any composite consumption occurring on a community indifference curve lying beneath point E at point E'[31]. If suppliers want to be responsive to consumers' preferences, but buyers are reticent or fail to effectively communicate, competitive potential may be unrealized because of what Keynes called inadequate aggregate effective demand. The micro distribution of the observed gross domestic product may be similarly impaired. If some market participants are unusually lax in sensing, searching, evaluating and negotiating market consumption opportunities, purchasing power and terms of trade will be turned inefficiently against them. Consumption won't occur at point E on the contract curve where purchasing power is mis-allocated, and will lie off the curve if Paretian negotiations are incomplete. Also, by analogy with the isoquants in the Edgeworth-Bowley production box, indifference curve levels may be renumbered downward if consumers' appreciative faculties are dulled by systemic traumas. A delicious meal may be tasteless to a distracted gourmet. And of course, the phenomenon of waste interpreted as a shrunken Edgeworth-Bowley consumption box should not be ignored. When goods spoil, or people spend their money on things they subsequently discover they didn't want, achieved well being will be less than potential.

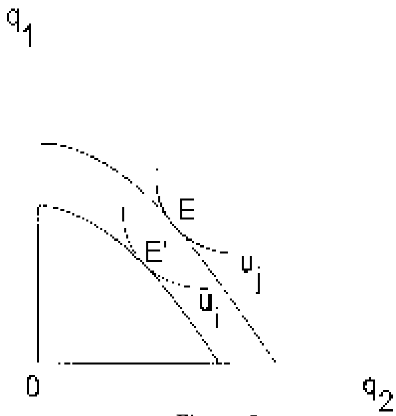


Figure 5

These demand side failures arising from various motivational lapses are compounded by supply side lapses in distributional efficiency, and abuses of public and private coercive power. Retailing inefficiencies prevent goods from reaching consumers in the optimal assortments, and excess profits, rents and other unearned incomes (seizures) resulting from anti-competitive practices and subjugation skew the distribution of income in favor of offenders, harming victims, and spawning inequity and injustice. This phenomenon illustrated in Figure 6 by forced movements away from point E toward D (where the kleptocratic elite receives an unjustly large

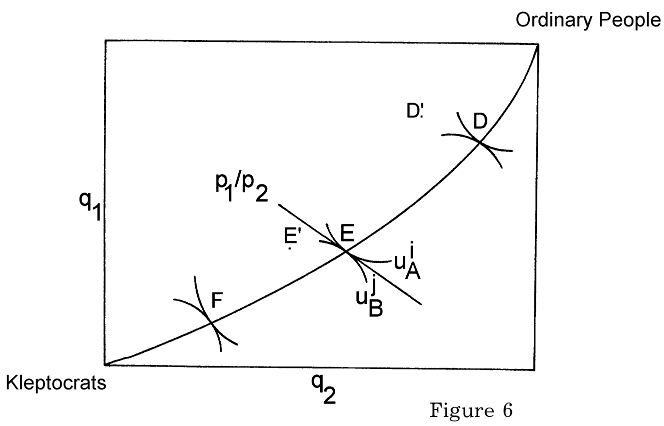


Figure 6

[31] As previously observed this also could be due to supply inefficiencies that render the quantity, quality and assortment of the goods and services available for consumption suboptimal.

share of GDP) along the contract curve, or off it diminish social welfare by sub-optimally distributing goods and services with insufficient regard for productivity, need or merit.

Russia's record in all these regards is disheartening. The collapse of the Soviet Union disordered retail distribution and unleashed a spate of asset-grabbing, asset-stripping, rent-seeking and financial malfeasance which concentrated control of wealth and income in relatively few hands, while impoverishing large segments of the population. These transfers never would have been tolerated in a classical regime, or in the imperfectly competitive economies of the mature west and stand as a monument to the failure of Yeltsin's criminally empowering free enterprise, even though some interpret gross inequity as a sign of Russia's success in its struggle to transition from communism to market capitalism. The disorganization of the retail market exemplified by the widespread persistence of barter; the Mafia's control over small vendors, and restraints in the provision of retail services through private and governmental collusion all testify to the exorbitant inefficiency of Russia's consumer sector. The standard of living for most of the population is poor not just because supplies are inadequate, but because the retail sector is disorganized and unjust. Figure 7 which arrays kleptocrats on the ordinate and the common man on the abscissa illustrates this outcome by comparing the achieved Russian social utility frontier (which takes account of all aspects of national compulsion and coercion) with the competitive ideal. It suggests that the average quality of Russian life is much lower than its competitive potential, with the klepto-elite faring exceptionally well compared with the plight of ordinary people[32].

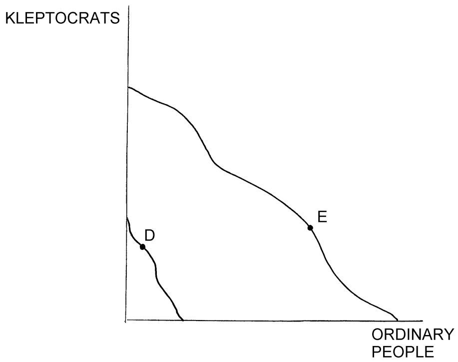


Figure 7

It follows directly from the foregoing survey that Russia's authoritarian laissez-faire market system is extraordinarily inefficient, compounding the harm inflicted by non-market coercion, subjugation and bureaucratic abuse in the complements of sets C, D, and E. Is this merely a consequence of the underdevelopment of the Russian market, or are there more fundamental forces at work? Persistent hyper-depression and negative economic growth suggest that Russian under-productivity and inefficiency cannot be adequately explained in terms of the historical underdevelopment of its market institutions. Classical and Schumpeterian theory both teach that economic performance should consistently improve as marketization expands. But this has not been the case. Yeltsin's authoritarian laissez-faire obviously is anti-productive, and growth inhibiting with few signs of improvement.

This doesn't mean that Russia lacks markets, only that they are severely circumscribed and distorted by moral hazard (centered around minority co-ownership

---

[32] Elizabeth Brainerd, «Winners and Losers in Russia's Economic Transition, «American Economic Review, Vol. 88, No. 5, 1998.Michal Rutkowski, "Russia's Social Protection Malaise: Key Reform Priorities as a Response to the Present Crisis," Social Protection Discussion Paper No.9909, World Bank, April 1999.

and managerial one-man-rule), coercion, subjugation and bureaucratic mis-administration, without the second best benefits of Soviet command planning and administrative discipline. Negotiated exchange is warped by the decriminalized exercise of market power. It is constrained by residual wage and price controls, and is often supervened by private and governmental compulsion, including the state ownership of resources, and part of the means of production. Russia's authoritarian laissez-faire economy is designed to serve the anti-productive interests of kleptocrats, cronies, tycoons, favored managers, and the Mafia, and won't prosper until this is rectified because market forces cannot be self-cleansing without the rule of law.