

# Transition to Freedom? The Cato Institute's Moscow Conference

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*In September 1990, the Cato Institute, a Washington-based libertarian policy research institute, held a conference in Moscow entitled **Transition to Freedom: the New Soviet Challenge**. It was co-sponsored by the Academy of Sciences of the USSR and other Soviet academic bodies. The conference was organised around two main themes: 'The Soviet Economy in Transition: From Planned Chaos to Spontaneous Order' and 'Beyond the Cold War: Creating a New Soviet-US Relationship'. Ross Parish, Professor of Economics at Monash University, gives an account of the conference discussion on the former theme.*

THE *Transition to Freedom* conference took place against a background of feverish debate and manoeuvring concerning the future course of economic and political reform in the Soviet Union. An account of some of the debates proceeding within and outside the conference has been given by Paul Craig Roberts ('Seven Days that Shook the World', *National Review*, 15 October 1990). Though he is very much the enthusiast, Mr Roberts's judgement regarding the significance of the conference seems fair enough:

The Cato Institute, with its full contingent of classical liberal thinkers, was at the right place with the right conference at the right time. The Soviet participants were drawn from both the radicals and the government, and a vast audience of Russians and Ukrainians overflowed the auditorium. Free minds met, and people yearning for a free society tested the mettle ... of Cato's stable of penetrating thinkers. For the first time in their lives, Soviet intellectuals and politicians met Western intellectuals who were confident of the superiority of a free society. It was good for their morale and fighting spirit.

Recent events indicate a reversion to authoritarian politics. It may be that the Cato Conference marked a high point in liberal advocacy in the Soviet Union. One hopes that this will not be the case, but fears that it might, so difficult — indeed hopeless — does the Soviet situation seem to be.

## Perestroika

*Perestroika*, or economic reform, has been on the Soviet agenda since 1985. Its aims, according to Abel Aganbegyan (an economic adviser of Gorbachev),

were to give greater priority to serving the 'needs of human beings' and less to industrial capital investment and military expenditure; to improve efficiency, promote technological progress and raise product quality; to achieve greater integration with the world economy; and to move from a command economy to 'a new economic mechanism with a developed market, distinct decentralisation, a higher motivation based on a pluralistic attitude toward property'.

Two major moves toward decentralisation of economic decision making were a law on state enterprises of 1987, and one on cooperatives of 1988. The former reduced the number of centrally-planned targets and indicators imposed on enterprises, and allowed them to engage in 'wholesale trade' with one another. According to *The Economist* (April 28, 1990) this reform has been a near total failure: it was envisaged that by 1990 orders from the central ministries would have dwindled from 100 per cent to 40 per cent of the enterprise's output, but, in fact, central orders still account for about 90 per cent of output.

The law on cooperatives has been more successful. Something like 180 000 cooperatives have been established in the last three years, their output constituting over 4 per cent of GNP. According to Yuri Kochevkin, 'So far, cooperatives have mostly grown on "empty space", by tapping previously unutilised resources. Their further development, however, increasingly depends on the restructuring of state-owned enterprises.'

Another legal change was the passage of a law which allows state-owned enterprises to be transformed into cooperative ones. Not much transformation has been accomplished, implementation of the law having run into serious difficulties.

There is a widespread consensus that *perestroika* has failed. Some of the evidence for this has just been stated. Many would regard the deteriorating performance of the Soviet economy as clinching evi-

dence. However, I would hesitate to accept poor economic performance as evidence of the failure of reform. Successful institutional reform would almost certainly involve short-term economic hardships, so that the evidence on economic performance is ambiguous.

The Soviet reforms followed and closely resembled those implemented in Hungary and other Eastern European countries. Nowhere do these attempts to decentralise and 'marketise' socialism seem to

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have had much success. Their failure has been attributed to the inadequacy of managerial incentives and constraints; in particular to the absence of private ownership of the firms' assets, and the 'soft budget constraint' under which they operate.

Private ownership is important because only through ownership can an economic agent have a secure right to the present value of an asset's expected future earnings. The proprietor-manager of a successful enterprise has a strong incentive to maintain and improve it: if he decides to enter some other business or occupation or to retire, he can take with him the fruits of his enterprise and luck by selling the business. *Per contra*, the manager of a state-owned enterprise has no such incentive: indeed the only way he can gain some of the value of the firm is by running it down, by consuming its assets. Similarly, if the manager's tenure is short, he has an incentive to neglect provision for the future for the sake of immediate returns. Where workers share in the profits of the firm, they have the same incentives to neglect the future for the present. Thus, to use *The Economist's* jargon, 'the ownership gap' in the self-managed enterprise leads to catastrophic 'short-termism'.

The soft budget constraint refers to the ability of an enterprise to continue operating when, according to rational capitalist principles, it should be closed down or put into receivership. The socialist enterprise may be kept in business by being given subsidies; by being excused from paying taxes; and by being allowed to borrow with little hope of ever repaying the loan.

A rather scathing verdict on the Soviet attempts at economic reform was given by a Polish economist, Jan Winiecki: 'They range from marginally important to misnomers to costly nonsenses'. He argued that in Western countries cooperatives have largely lost out in competition with the private sector. Thus he expected that cooperatives would not have much of a future once private ownership was allowed to compete. He regarded leasing in agriculture as a costly non-solution, but far worse, in his view, is the leasing of whole factories to workers' collectives. The principal-agent problem is acute because it inheres not only in the relation between the state as owner of the assets and the workers' collective as lessee, but also in that between the management and the rest of the workers. 'Leasing to collectives of employees would, thus, generate two layers of agency costs and possibly result in higher transaction costs than is the case for state ownership pure and simple.'

His conclusion, with respect to developments at the USSR level (as distinct from individual republics) is that 'no privatization in the narrow sense of the word, that is turning state or otherwise collectively-owned assets into private hands, has been occurring in the USSR so far. In fact, no laws laying down the rules in this respect have been devised, let alone passed by the legislatures'.

A paper by Alexander Tsytko (Professor of Philosophy at Leningrad University) gives, I think, an excellent account of the socio-political reasons why the Eastern European countries hesitated to undertake thorough-going market reforms, and why the Soviet Union lagged in initiating reforms. I will quote from his paper at some length.

On the whole, one may say that in the 1970s and even in the 1980s, the intellectual attitudes of Soviet and East European countries were motivated by the ideals of the Prague Spring of 1968. The dream of 'socialism with a human face' which took hold in the mind of the intelligentsia of Eastern Europe not only stimulated democratic initiatives but at the same time gave them an ideological legitimacy. As late as December 1989, during the collapse of the political structures of East Germany the overwhelming majority of that country's intellectuals continued to believe that a 'pure' Marxist socialism was possible, that the people of East Germany would be able to accomplish what 'the Russians or Poles, who never understood Marx properly, could not do ...

Today, in September of 1990, as we survey

the results of more than five years of our efforts to revive the socialism built in the USSR in the 1930s, it becomes clear that we all had to go through this third way syndrome ... First of all, the mentality of people who had lived their entire lives in totalitarian societies, or rather, who had led their existence in conditions they consider unnatural, took its toll. It is hard, very hard to admit that your life and your work are being senselessly wasted, that you are living in an unnatural, false society, headed with your country for the dead end of history. Therefore, the hope that real socialism, a real socialist economy would be, in the end, successfully revitalized and made more rational, was a comfort to the soul, enabling people to bear the hardships of everyday life. No less importantly, many people found it difficult to reject the socialist legitimacy of their state with its Marxist ideology. Having made such a step in the conditions of the Communist party's monopoly on power, the reformer ceased to be a reformer and became a traitor to the ideals of socialism with all the ensuing consequences ...

It was even more difficult to avoid this transitional ideology in our country, burdened by the communist birthright, a country that had sacrificed tens of millions of lives in the name of the chimera of the Communist Eden. What makes perestroika different from the democratic revolutions of Poland, Czechoslovakia, and East Germany, is the fact that it began from the top, at the initiative of the ruling Community Party. If in Poland everything was started by the opposition — here, everything was started by the 'apparatchiks' Gorbachev and Yakovlev. They not only generated perestroika but created their own opposition. In Poland or Czechoslovakia, the people capable of heading a reformist movement were outside the party; therefore, from the very beginning, their political activity was directed at the dismantling of party and state structures. Therefore, from the very beginning, the struggle in these countries was against the communist legitimacy of the state, against communism and socialism. Here, everything was different.

Perestroika began within the framework of the communist legitimacy of our state and, in its conception, was intended to strengthen the socialist and communist nature of our society. Here, again, characteristics peculiar to Russia were in evidence. Typically in this country, with the exception of the 1917 revolution, all revolutions were launched from above, intended by their initiators as a means to fortify the existing system ...

It took us five wasted years of perestroika to understand that, essentially, the revitaliza-

tion of Stalinist socialism is impossible, that there is no third way between modern civilization and socialism as it is. The market cannot be combined with a government monopoly on the organization of labour or with public ownership of the means of production. A return to the market is impossible without the restoration of various forms of private and collective enterprise, without broad-based privatization. It is impossible to have the rule of law without a multi-party system, without renouncing the communist monopoly on power. It is impossible to adopt moral values and to earn the right to return to civilization, to the European home, without rejecting the idea of the dictatorship of the proletariat, of the forcible transformation of society.

In other words, owing to five years of experience of trying to reform real socialism and to the experience of the political economic reforms of the 1970s and 80s in Eastern Europe, the realization that we all face the need to restore everything we had rejected in the course of socialist transformation, to restore the structures and institutions of civil society, has become inevitable.

### Privatisation

There was near unanimity among conference speakers that privatisation of property was an (if not **the**) essential element in establishing a market economy. A number of suggestions as to how existing enterprises might, in practice, be privatised, were made. Issues canvassed included whether assets should be sold or given away (literally or metaphorically) and, if the latter, to whom. Now, it has been said by Max Beloff (writing in *Encounter*, July-August 1990, p.5) that 'the spectacle of Western experts on "privatisation" giving their advice to Eastern European governments where none of the underlying structures of law and economic rationality are in place would provoke laughter were the consequences likely to be less tragic'. This characterisation hardly applies to the Cato Conference. American participants, in particular, tended to emphasise the importance of institutional, cultural, and ideological factors in the formation and functioning of market economies. In fact, Beloff's cautionary sentiments were repeated by Douglas North: 'The simple minded notion that "privatization" is all that is needed to get faltering and failed economies on the path to growth is a travesty of institutional reasoning that reflects the primitive understanding of most economists about economic history and growth. Creating efficient factor and product markets is a complicated process about which we know all too little.'

North opened his paper with the statement, 'The central argument of this essay is that institutions and ideology together shape economic performance'. He went on to say:

Institutions are the rules of the game in a society; more formally, they are the humanly devised constraints that shape human interaction. In consequence they structure incentives in exchange, whether political, social, or economic. Institutional change shapes the way societies evolve through time and hence is the key to understanding historical change.

Yet western neo-classical economic theory is devoid of institutions and therefore of little help in analyzing the underlying sources of economic performance. It would be little exaggeration to say that while neo-classical theory is focused on the operation of efficient markets, few western economists understand the institutional requirements essential to the creation of such markets since they simply take them for granted.

The theme of the limited usefulness of neo-classical theory to the task of reform of the Soviet economy was touched on by a number of speakers. Henry Manne suggested some reasons why this is the case:

In the main, the West's development of capitalist, private property, free market institutions has been unplanned and unselfconscious. The system has evolved from historic origins little understood or recognized today. And it represents an incredibly complex intermixture of political, economic, cultural, legal, and technological factors. Indeed the subject of how the system developed has been so complex that most western, and especially American, scholars have largely despaired of even dealing methodically with it.

There are certain factors within the academy that have reinforced this tendency. The dominant Keynesian thinking from the late 30s to the mid-60s eclipsed the older, more philosophically oriented approaches, and the development of mathematical economics and econometrics (especially as aided by the introduction of the computer) did nothing to promote intellectual considerations of market institutions. Added to this, of course, was the heavy flirtation — in many cases a conjugal relationship — of many western academics with Marxian and other socialist ideas. Ironically, however, it was during this same period that some of the most important developments in our intellectual understanding of free market institutions occurred, and it is largely to these, as well as to some of the aforementioned classical writers that scholars and people of practical affairs are now turning.

The developments referred to by Manne are the work of the 'Austrian' economists, especially Mises and Hayek, which embraced such important concepts as

the subjective theory of value, the evolutionary nature of social and legal institutions, and the impossibility of socialist calculation as a means of determining relative prices correctly; the modern Public Choice School, founded by Buchanan and Tullock, which offers an explanation of political and bureaucratic behaviour using the same axioms as economic theory; and property rights economics, of which the principal founders have been Alchian, Coase, Demsetz, and Williamson.

### **Institutions, Culture, Ideology**

I now will report briefly on the discussion of some of the non-economic factors underpinning (or undermining) market economies.

North sees economic efficiency as depending on low transaction costs, and the legal system playing an important role in keeping them low, both by defining property rights clearly, and by the enforcement of contracts. Other influences on transaction costs are the size of the market, and ideology, which constrains people to behave in moral and predictable ways.

William Niskanen also stressed the importance of the legal system as one of the three basic underpinnings of the market: the other two being the accounting system and appropriate cultural attitudes. He pointed out that property rights in the Soviet Union fall far short of the desiderata of being exclusive, alienable, partitionable, and extensive.

With respect to Soviet accounting practices, Niskanen reported that Western businessmen who have considered joint ventures with socialist firms have found their accounts to be 'almost worthless, either for internal management or external monitoring ... The accounts ... are designed to provide the insatiable data demands of the state planning system' and are mostly concerned with physical flows. He went on to say:

One of the major advantages of a market economy is that it minimizes the necessary data flow, since prices convey most of the information necessary to coordinate economic activity among firms and consumers. A financial accounting system, in turn, provides the information necessary for firm managers to respond correctly to the market prices of inputs and outputs. A major program to train accountants and develop modern financial accounts would be among the highest return investments in the Soviet economy.

Niskanen quoted Wilhelm Röpke on the importance of cultural attitudes to the success of the market economy:

An intensive and extensive economic exchange cannot exist or last very long without a minimum of natural trust, confidence in the stabil-

ity and reliability of the legal-institutional framework (including money), contractual loyalty, honesty, fair play, professional honour and that pride which makes us consider it unworthy of us to cheat, to bribe, or to misuse the authority of the State for egoistic purposes.

A similar argument was made by North:

Formal rules are only a part of the institutional matrix. They must be complemented by informal constraints — extensions, elaborations, and qualifications of rules that 'solve' innumerable exchange problems not completely covered by formal rules and that hence have tenacious survival ability ... Routines, customs, traditions, and culture are words we use to denote the persistence of informal constraints.

Niskanen asserted that 'the attitude most incompatible with a market economy is a profound and pervasive sense of envy'. Charles Murray, whom I consider to be one of the leading moral thinkers of our time, reversed the direction of causation and argued that the socialist 'ideal of egalitarianism, translated into political terms, is an engine for generating the maximum amount of envy'. His argument is that:

If equality is a moral ideal any specific instance of inequality is morally suspect. It is impossible to be innocently better off than another person ...

The egalitarian ideal wants people to be equal, and the reality is that people are **not** equal. They are not equal in tastes, talents, aspirations, kindness, or any other human quality. On the contrary, they are infinitely various. A society must be constructed to provide a legitimate way for these infinitely various ways of being human to express themselves, for the same reason that the boiler of a steam engine must have a pressure valve — otherwise, it will blow up. The expression of individuality must mean inequalities in the things people do and the things people have. Conversely, the more successfully a society achieves material egalitarianism, the greater the resentment at the inequalities that remain, and the greater the pressure that begins to rupture other portions of the social fabric, and rupture human relations as a by-product.

Murray's remarks on egalitarianism are part of a general argument that turns on its head Marx's assertion that capitalism alienates: 'The ideals of socialism push people apart. Socialism atomizes.' Murray's argument is as follows: People pursue happiness mainly by actions and these actions are usually social. He quotes Burke: 'Men ... are led to associate by resemblances, by conformities, by sym-

pathies.' He calls the process whereby human relationships are formed **affiliation**. 'Affiliation is a means whereby people of common values are enabled to live by those values.' The satisfaction one gains from achievements, including those attained through affiliation, is higher, the greater the effort involved, the more control one exercised over the outcome, and the more important the function performed. Limited government allows great scope for activities involving affiliation: indeed, in Murray's words, it 'virtually forces ... society to generate complex, rich, and rewarding personal relationships based on cooperation and mutual help'. By contrast, socialism involves a high degree of government involvement and control of people's lives, and hence diminished scope for important functions to be performed by affiliations. 'Take away the functions, and you take away the purposes of community and family.'

The transition of the Soviet Union to a market economy is hindered not only by socialist egalitarianism but also by Marxist anathematisation of profit, speculation, etc. Several speakers suggested that public re-education programs be implemented 'to dispel the misunderstandings and prejudices about private property, profit, freedom of contract, private enterprise, and competitive markets that are still endemic in the Soviet Union today'.

Such a program would doubtless be more successful among a people profoundly disillusioned by socialism than it would in the West, where anti-capitalist sentiment is also widespread. But what chance is there that a capitalist re-education program will be implemented? Or indeed, that the needed legal and other institutional reforms will be made? To return to Alexander Tsypko:

The paradox of history is that the Bolshevik party, having systematically and consistently eliminated over decades the organic structures of industry and social life, the remnants of the civil society that was never allowed to emerge in Russia, is now forced to assume the responsibility for restoring the world it once fought. Will it be capable of solving this task? Will it be able to restore the ground on which, essentially, there will be no room left for its rule?...

Today, everyone is talking of the need to reject the communist Marxist legitimacy of our society. But can we, after seventy years of communist existence, return to the traditional historical legitimacy of our state? No signs of such a transition can be anticipated so far.

All of this suggests the need for a global, broad, historical look at the processes occurring today in post-communist countries. It seems to me that the transition from the paradigm of reform to that of restoration can allow us to better understand what is happening to us, and what tasks lie ahead of us.

The tasks of restoring a civil society and a market economy are indeed formidable, and may not even be possible. As a Russian is supposed to have said: 'We know that you can turn an aquarium into fish soup: the question is, can you turn fish soup back into an aquarium?' Another Russian joke on the same theme: 'There are two ways to solve the crisis of the Soviet economy. The realistic way is to have people from outer space come and straighten out the mess. The fantastic way is for the Soviet people to sort it out on their own.'

#### List of Conference Papers

Aganbegyan, A., 'Restructuring the Soviet Economy: Partial Reform versus Fundamental Change'.  
 Bernholz, P., 'Property, Markets, and Money: Guidelines for Reform'.  
 Bogomolov, O., 'Half or Full Reform?'.  
 Buchanan, J., 'The Minimal Politics of Market Order'.  
 Dolan, E., 'Financial Aspects of Soviet Economic Reform: Controlling the Threat of Hyperinflation.

Comment on Bernholz'.

Gilder, G., 'Implications of the Information Revolution for Marxism, Freedom, and Wealth'.  
 Kochevkin, Y., 'Prospects of Economic Privatization in the USSR'.  
 Lavoie, D., 'Glasnost and the Knowledge Problem: Rethinking Economic Democracy'.  
 Manne, H., 'Perestroika and the Limits of Knowledge'.  
 Murray, C., 'The Pursuit of Happiness Under Capitalism and Socialism'.  
 Niskanen, W., 'The "Soft Infrastructure" of a Market Economy'.  
 North, D., 'Institutions, Ideology, and Economic Performance'.  
 Pilon, R., 'Individual Rights, Democracy, and Constitutional Order: On the Foundation of Legitimacy'.  
 Popov, G., 'Welcoming Address'.  
 Raico, R., 'Marxism, Liberalism, and the State'.  
 Roberts, P., 'Marx, Markets, and Ownership'.  
 Tsytko, A., 'Restoration of Capitalism or Revitalization of Socialism?'. Policy

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