

**DISCUSSION PAPER SERIES**

No. 628

**THE POLITICAL ECONOMY OF  
TRANSITION IN THE SOVIET UNION**

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January 1992

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January 1992

## ABSTRACT

### The Political Economy of Transition in the Soviet Union\*

This paper analyses the political economy of transition in the Soviet Union since *Perestroika*. It is argued that no major sequencing errors were made and that important steps were taken in the direction of democratization and the introduction of a private sector. Gorbachev's major error can be attributed to the macro mismanagement from 1985 onwards, leading to a loss of a central control and to the disintegration of the Soviet Union, unleashing nationalist forces and necessitating an increase in the speed of economic transition, in a situation where the political conditions for further reform had not yet been met. After the disintegration of the Union, stalemate between republics over the sharing of the costs of transition and stabilization delays the adoption of necessary economic measures.

JEL classification: P20, O52

Keywords: transition, Soviet Union, political economy

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\*This paper is produced as part of a CEPR research programme on *Economic Transformation in Eastern Europe*, supported by a grant from the Ford Foundation (no. 919-0383), whose help is gratefully acknowledged. I am grateful to Jorge Braga de Macedo, Mathias Dewatripont, Jean Pisani-Ferry and participants at the meeting for the preparation of the forthcoming special *European Economy* issue on the Soviet Union, for which this paper was written.

Submitted 12 December 1991

## NON-TECHNICAL SUMMARY

This paper uses the sequencing tactics framework put forward in Roland (1991) to evaluate the course of economic transition in the Soviet Union since *Perestroika*. This implies a four-phase sequencing: first, democratization; second, privatization; third, liberalization; and finally, restructuring. These four phases should not be seen as separate blocks, but as part of a timing mechanism, each phase continuing and expanding as a new one starts.

Under Gorbachev the first two steps – democratization and privatization – were initiated. The next step is price liberalization, which is now politically possible and desirable. As with Poland in 1990, it is too soon to start the fourth phase; restructuring, which implies limitations, *inter alia* concerning the probability of success of stabilization programmes.

It is argued that Gorbachev made no major sequencing error. The main forces of resistance to the August putsch were those who would lose from the elimination of democracy and the private sector. Constituencies had been created that did not exist a few years earlier, and these forces proved sufficiently effective to face a divided and incompetent putschist alliance.

Gorbachev's failure is better explained as one of speed. He failed to take advantage of the momentum created by the progress in democratization and in the growth of private activity, to pass the Rubicon of price liberalization. Conservative opposition was too strong to permit such a decision, which would not have been a problem had the economy continued along a path of relative macroeconomic equilibrium. Gorbachev is responsible for significant macroeconomic mismanagement, however, for which the Soviet people rightly blame him.

The loss of control over macroeconomic equilibrium reinforced the dislocation of the command system itself. Gorbachev's macroeconomic policies brought forward the time by which a decision either to liberalize prices or to strengthen state controls had to be made. He was unable to proceed with either and let the situation deteriorate. This necessarily led to increased polarization between conservative and reformist forces as well as increased nationalist polarization, which eventually undermined his own position and lost him all the popular support he had gained with *glasnost*.

The disintegration of the Union increases the urgency of price liberalization. The introduction of free market prices will lift all suspicion over who is subsidizing whom. Quarrels over the terms of trade will otherwise lead very quickly to a retention of exports on all sides.

Price liberalization is not enough, however. The different republics will all have heavy transition and stabilization costs to bear and each republic's share in the overall transition cost is hard to identify. There will therefore be a great incentive for republics to shift some of their own transition costs onto others, leading to dangerous and sustained stalemate and prolonged delay in the implementation of reform programmes. Cooperation among the former republics is unlikely, and the absence of cooperation will probably lead to disastrous economic results. Only very generous and conditional help from the West could create the incentives for economic and monetary cooperation among the republics.

## INTRODUCTION.

The transition of centrally planned economies to market economies is a historically unprecedented case of large scale change of economic institutions. This change is unseparable from the political process. It is quite clear in the former USSR where reform plans for stabilization, liberalization and privatization are linked to a constitutional reshaping of the links between Russia and the other republics. It is also true in other countries where national conflicts do not play such an important role but where the abolition of the one-Party system appeared to be a precondition to consistent radical economic reform.

Quite a number of questions of political economy are raised by the transition from plan to market:

1) which groups will benefit from the different transition measures and which groups will be hurt?

2) how will the potential opposition between different interest groups be reflected in the political decision-making process, given the existing economic institutions, and what will be the influence of changes in the design of political institutions on the way this opposition is reflected, influencing in its turn the feasibility of given reform packages? In other words, what are the required institutional changes in the political decision-making process necessary in order to make the transition succeed?

3) what can be said about sequencing tactics and the way it takes into account the dynamic political constraints of the transition?

In a first section, we will survey some results that can be mobilized from the recent literature on political economy and try to sketch the framework of the analysis that will be used.

In a second section, this framework will be used to analyze the evolution of the transition process in the Soviet Union since 1985.

In a third section, we will try to define, in function of the political economy analysis, the necessary next steps of transition.

## 1. SOME RECENT RESULTS OF THE LITERATURE ON POLITICAL ECONOMY.

There is not yet much economic literature addressing the specific political economy problem of the transition from plan to market. It is however useful to mobilize some insights derived from the recent political economy literature on related subjects.

1. A first important theme is that of *conservative opposition*, i.e. the extent to which particular groups of the population who will be hurt by the transition process can block the economic reform. This theme is developed by Fernandez and Rodrik (1990). In the context of trade reform, they show how the existence of transition costs and uncertainty concerning the way the gains and losses of reform are distributed in the population, may lead to a *status quo* bias. Trade reform implies a shift of labor from the import-competing to the export sector. It is assumed that shifting sectors implies a known investment cost, common to all, and an unknown transition cost, different across individuals. Even though the overall gain from trade reform is unambiguously positive, one might have cases where the expected individual transition cost is such that a majority will vote against the reform, whereas, if the individual transition costs were known, reform would enjoy a majority support. Moreover, as the opposite case might also occur, (i.e. the reform voted *ex ante* by a majority might hurt a majority *ex post* when transition costs are known), the expectation of reform reversal can tend to narrow the vote in favor of reform compared to a situation where reform is expected to remain. Hence a status quo bias.

The combination of transition costs and uncertainty is also considered by Roland (1990a) as a potential danger to the success of the transition from plan to market. Two other elements are also present: collective action failure and path-dependency. In the absence of established democratic institutions, changes desired by a majority might not come about because of the public good character of collective action and the free rider incentive associated to it. The perception of the reduced costs of participation to collective action might provide an explanation for the rapidity of the collapse of the communist regimes in Eastern Europe. Path-dependency might create an obstacle in a double sense. From a deterministic point of view, initial conditions of the transition might represent an obstacle to change to a more efficient system as pareto-improving but time-inconsistent transition measures can be rejected. From a stochastic point of view, unexpected

events occurring during the transition period might create a lock-in effect towards an undesired and inefficient set of institutions, because of the network externalities associated to institutions.

2. Another important theme is that of the *legitimacy* of governments that have to govern the transition process. This concept is not easy to grasp analytically, but insofar as one may equate legitimacy with popular support, an easy way to understand legitimacy, especially in a democratic context, is to look at the probability of being reelected, or more generally, the probability of remaining in power in the future.

This probability influences government policy, as shown by Alesina and Tabellini (1990). In a two Party framework, where both parties differ concerning the type of public good to be produced, it is shown that the level of public debt will be higher the lower the probability of reelection. Indeed, the current government tends less to internalize the future cost of issuing today's debt if it has a low reelection probability. Even in the absence of precommitment, a government with a 100% probability of being reelected will balance the budget. The higher the degree of "polarization" between the two parties, understood here as the extent of disagreement on the structure of public expenditure, the higher will be the deficit bias.<sup>1</sup> Transposed to the general problem of transition from plan to market, these results imply that governments with low legitimacy will tend to be "soft" on budget cuts and will in general refrain from taking policy measures bearing short term costs to them and yielding long term benefits that are likely to be reaped by their successors.

Legitimacy and polarization are particularly important issues when discussing issues of macroeconomic stabilization. Alesina and Drazen (1989) provide a framework to try to explain why stabilizations are delayed. The process leading to stabilization is modelled as a "war of attrition" between two conflicting groups, each trying to impose the full costs of stabilization on the other group. Delaying stabilization is costly to each group but these costs differ and are not known by the other group. When these costs are known, stabilization occurs immediately. Otherwise, it will be delayed until it becomes advantageous for the weakest group to concede, because the cost of further delaying stabilization would become greater than the expected benefit from waiting. The more inegalitarian the distribution of

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<sup>1</sup> Similar results are obtained by Persson and Svensson (1989). If a conservative government with low preference for public expenditures knows it will be replaced by a left-wing government with a higher preference for public expenditure, than it can constrain the latter to lower its expenditure level by running a deficit.



income, the longer the delay because the perceived likelihood that the opponent group is weaker, and will thus give in first, is higher. However, the higher the monetization as well as the distortionary effects of budget deficits, the earlier will be the stabilization. A higher polarization in society also delays stabilization because its burden becomes more unequal. These results are highly relevant to the Soviet case, where stabilization has become a key issue, and where there is great uncertainty concerning group-specific burdens of stabilization.

The role of political instability, lack of legitimacy and polarization on fiscal behaviour of governments and delays or failures to stabilize has been shown in the empirical work of Cukierman, Edwards and Tabellini (1990) on LDC's.

When a minimum amount of legitimacy allows governments to decide on the political agenda, i.e. the order in which measures are proposed as well as their content, political constraints nevertheless continue to exist, whether through the possibility of parliamentary refusal or through collective actions that lead to a major political crisis. This agenda-setter framework, due to Romer and Rosenthal (1979) is used by Dewatripont and Roland (1991) to analyze the role of political constraints on industrial restructuring in the transition from plan to market. Economic reform is presented as a shift from overall low to high productivity. There is a heterogeneous workforce with three groups of individuals characterized by different levels of disutility of effort, and thus different levels of rent, unknown to the government. Economic efficiency requires a shift towards a high productivity level, with only those with the lowest disutility of effort keeping their jobs. The impact of political constraints on optimal reform paths is then analyzed as well as the effect of the relaxation of political constraints from a unanimity to a majority rule. Two main ingredients of the model, besides the existence of political constraints, are informational asymmetry and the absence of government precommitment. Among the results, it is shown that gradual reforms can be optimal, because there are cases where the efficiency loss implied by gradual redundancies is smaller than the budgetary cost of immediate reform, as gradualism allows to yields a net gain in rent extraction through incentive compatible revelation of information. Another result is that under majority rule, a majority can vote for measures that hurt majority interests because the government can use the credible threat of future reform proposals hurting a specific group to have that group vote a reform proposal that would less hurt its interests, whilst hurting other groups. In other

words, groups can be played against each other. The agenda-setter framework is more directly normative in so far as it defines optimal reform paths taking into account the dynamic political constraints of transition. This framework can be used to address other dynamic problems than the problem of restructuring.

3. Another theme of political economy that is addressed in specific work related to the transition is that of *speed*. Lipton and Sachs (1990) analyze the transition program in Poland and its implementation in 1990. Speed is important because the new democratic governments should use their legitimacy and popularity to implement rapidly measures that will anyhow hurt important parts of the population. This is especially true in the case of stabilization where delay in decision-making only undermines government support and makes the necessary later measures even more painful.

Roland (1991) also emphasizes the importance speed can play in the transition period. In view of the fundamental systemic changes implied by reform, a great number of economic agents are thoroughly uncertain about their net expected individual gains or losses from the transition. As a result, the attitudes of these "uninformed" agents towards economic reform is liable to change through time. It is argued that it is precisely the behaviour of this group that politically constrains governments in the transition period. The strategic position of these types of agents for or against reform will be determined in function of two elements: balance of power changes on one hand, and the cumulative individual welfare impact of past and present reform measures. All other things remaining equal, if uninformed agents observe a signal of balance of power change, say in favor of reform, they will tend to support reform because mimicking others can be rational when you are uninformed. Balance of power changes thus have a (weak) self-enforcing property. On the other hand, if these agents are only able to assess their individual net expected gains or losses from the measures proposed on the current government agenda, their attitude towards reform at any moment in time will depend on the cumulative impact of past and present reform measures on their individual welfare. Indeed, as a rejection of reform implies a reversal of already adopted reform measures, current proposed measures will lead individuals to abandon the camp of reform only if their expected loss from current measures exceeds their cumulative benefit from past reform measures. Two conclusions are drawn from this analysis. First of all, a correct sequencing tactics for governments consists in first implementing measures that benefit a majority and hurt a minority, and then

to use this favorable balance of power change to implement measures that hurt more important interests. Conversely, wrong sequencing tactics will lead to conservative and populist backlash. Second, speed is also important since the self-enforcing character of balance of power change allows to capitalize on favorable balance of power shifts by quickly implementing measures that hurt more important interests. The failure to take advantage of such shifts can block reform if the implied welfare losses of the measures ahead are important. Speed is thus important. Arguments for speed should however not lead to neglect the importance of political constraints. On the contrary, they must be deduced from dynamic balance of power considerations.

This framework of sequencing tactics leads to the formulation of a four-phase sequencing: 1) democratization, 2) privatization, 3) liberalization, 4) restructuring.

These are broad headings and should not be understood in a narrow sense. Democratization includes not only the establishment of democratic institutions, but also the institution of a stable and predictable legal framework for the market economy, as well as the setting up of the necessary fiscal, monetary institutions, including an independent central bank. Privatization refers not only to the sale of state assets to private hands, but more generally to the introduction and extension of a private sector in the economy, as well as the increase of its overall share in the economy. Liberalization concerns the freeing of prices as well as the introduction of a convertible exchange rate. Restructuring refers to the closing of non profitable enterprises as well as a shift to a new structure of production of goods and services adapted to an open market economy.

These four phases should not be viewed as blocks that should be put one behind the other, but on the contrary, as a timing of the start of the phases, each phase being continued and expanded when a new one is being started.

The political logic behind this sequencing order is that to which referred above. These phases are presented in order of decreasing popularity and increasing political difficulty. Democratization increases the welfare of a great number and hurts only very few interests. Equally, the introduction of a private sector gives to consumers goods and services that the former planning system failed to provide. On the other hand, it hurts more interests than privatization and creates political tensions around the higher inequality in the distribution of income. Liberalization hurts many groups in the population as the real purchasing power of many will have to be reduced.

Restructuring is certainly the politically most difficult phase, as workers will resist the closing down of their enterprises. In the shortage economy the guarantee of employment in the enterprise serves as the basic social security device. Moreover, the enterprise is also the main source of rents for many individuals.

There is also an economic logic to this sequencing. Restructuring cannot proceed on a large scale unless prices have been liberalized earlier on. Indeed, applying a rule of bankruptcy is not credible unless market-clearing prices have been established, giving information concerning enterprises without future. Price liberalization may not lead to the expected supply response, unless there already exists a private sector with profit-maximizing entrepreneurs searching for profitable opportunities. Of course, the share of the private sector is necessarily limited in an economy where prices are not yet liberalized, and large scale privatization of the economy can only be achieved after price liberalization. Our argument however only implies that there should be, prior to price liberalization, a significant private sector that will be one of the main constituencies for further reform. Similarly, a private sector cannot develop unless there exists a legal framework guaranteeing the protection of private ownership.

Note that, contrary to other plans for sequencing, we have not included stabilization. Indeed, macroeconomic stabilization is only necessary for certain former planned economies where macroeconomic disequilibrium is very important. Economic logic suggests, in that case, that stabilization should proceed together with price liberalization. The issue of stabilization as such in the early phase of transition is however not common to all former centrally planned economies.

In the following sections, we will use this four-phase sequencing order and its political economy framework of sequencing tactics to analyze the evolution of the situation in the USSR since perestroika. This framework will also be used to analyze prospects concerning the future measures necessary in the region constituted by the former Soviet Union.

From a methodological point of view, one is confronted with a difficulty when trying to analyze the political economy problems of the transition, especially because one faces a changing institutional framework. Indeed, in an unchanged institutional environment, one might define an appropriate measure of political constraints: the weight of different political parties and coalitions in Parliament, votes in general elections, voting intentions, etc. However, in a situation where institutional change is endogenous and is

itself at stake in the transformation process, it is very difficult to define a measure of political constraints, even though the empirical extent of these constraints is certainly a crucial factor determining the future of transition. Opinion surveys might prove very useful for assessing political constraints on certain policy measures, but the conclusions one may draw from such surveys is very often ambiguous. The way the questions are asked may influence the responses. Moreover, popular opposition to given measures, as revealed through opinion surveys, does not necessarily transform into a binding constraint on government action, unless overt organized action such as strikes, demonstrations, feeding into a political crisis, leads to block government decisions.

## II. THE USSR SINCE PERESTROIKA

### 1. DEMOCRATIZATION.

Perestroika has indeed started with political change, and this is certainly the most striking achievement of Gorbachev's leadership compared to the dismal economic performance. Glasnost and the early democratization was certainly a very important move for overcoming the collective action failure referred to above.

In a first phase, there was widespread scepticism concerning the credibility of this democratization process. Moreover, fears were expressed concerning the irreversibility of the first democratic changes that were instituted. To understand the dynamics of the process of democratization, one must take a closer look at the functioning of the Soviet political institutions.

When Gorbachev came to power in March 1985, this was done with the help of conservative fractions inside the politburo, and it was A. Gromyko who presented the new soviet leader to the Central Committee. This Central Committee was still essentially Brezhnevian, being elected by the 26th Party Congress of 1981. If we assume that Gorbachev had very reformist intentions from the beginning, then we must acknowledge the importance of political constraints, represented by the existing Central Committee and Politburo when he came to power. The first thing to do to broaden his power base inside the Party, was to have a new Central Committee elected. This is what happened at the 27th Party Congress in 1986 where 38% of the old

Brezhnevian Central Committee was removed<sup>2</sup>. The new Central Committee still however had a very conservative profile and Gorbachev was at pains in the subsequent years to have the most conservative elements removed<sup>3</sup>.

During his first two years in power, Gorbachev did not give any tangible and credible signs that he was willing to pursue a policy that would basically differ from that of Andropov. Two of his first moves as Secretary General were the anti alcohol campaign and the campaign against "unearned incomes" (*netrudovye dokhody*). It is only the January 1987 plenum where the new policy orientation towards glasnost was clearly put forward. This most visible effect was the change in the media where very critical articles towards the regime and the economy started being published<sup>4</sup>.

Glasnost started to unleash public freedom of speech and crucial issues started to be debated publicly without fear. The so-called non formal groups and organizations started to be established. People began to realize that they could organize.<sup>5</sup>

However, these new freedoms established by glasnost did not bring about a significant change in the political decision-making process, in the sense of the institution of pluralist political institutions. The monolithic structure of the Party remained the same and conservative and reformist fractions were not allowed to be formed inside the Party apparatus. Moreover, public opinion became increasingly conscious of the fact that there was absolutely no constitutional mechanism allowing the people to control the Party.

The impetus towards political change and the move towards a pluralist multi-party system started at the 19th Party conference in June 1988<sup>6</sup>.

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<sup>2</sup> See Hough (1988) for more details on early personnel moves of Gorbachev.

<sup>3</sup> Of the 307 Central Committee members elected in february 1986, 303 still were there in february 1989. All were top officials in Army, government, etc. 185 of them had reached pension age and 142 of them had worked more than 10 years in central party bodies. *Argumenty i fakty*, 3-2- 1990, p. 6.

<sup>4</sup> Shmelev's (1987) article in *Novyi mir* produced a great effect at that time on public opinion, by breaking many taboos, including the necessity of a huge private sector, of free issuing and sale of shares, the convertibility of the ruble, free trade zones and, last but not least, the necessity of a certain amount of unemployment in order to avoid inflationary tensions on the labor market. Similar articles would have never been published under the Brezhnev period. Moreover, their circulation as samizdat would certainly lead to repressive measures against their authors as was the case in the seventies and the early eighties.

<sup>5</sup> Laws confirming these changes came however later in the process. The law on the press was adopted in June 1990 (*Izvestiia*, 9-6-90, pp. 1-3). The law on public associations allowing non violent parties was voted in May 1990 (*Izvestiia*, 31-5-90, pp. 1-4).

<sup>6</sup> *Materialy XIX vsesoiuznoi konferentsii kommunisticheskoi partii sovetskogo soiuzna*, politizdat, 1988.

Initially, the measures adopted appeared very modest. First of all, a greater role in political decision-making was to be given to the Soviets through the People's Congress and the Supreme Soviet. The latter was to be transformed in order to perform the same functions as a modern Parliament with full-time representatives. The second major decision of the 19th Party conference was to compel local and regional Party leaders to become candidates for the Soviet elections at the different levels. Non Party candidates would be allowed and the number of candidates would have to exceed the number of mandates.<sup>7</sup> The idea of compelling Party leaders to face electoral tests was considered an indirect way of having people control the communist Party. A hated Party bureaucrat would have to compete with other candidates, including non Party candidates, and if he was not elected, then the Party would have to reach the conclusions. One realizes very easily that this is only a very indirect measure of democratic control over the Party. In the March 1989 election for the People's Congress, Solovyev, the Party leader from Leningrad was not elected, as was the case for many party leaders throughout the country.<sup>8</sup> The Leningrad party leadership exercised some self-criticism, but decided not to retire. Gorbachev had to intervene personally in the Leningrad Party plenum to obtain their resignation<sup>9</sup>. Moreover, the admission of non-party candidates and the obligation of having a higher number of candidates than mandates did not introduce multi-party political competition.

However inconsequent they were, these measures initiated an impetus for further political change. The election campaign of March 1989 revealed some genuine competition at different levels and in different places between conservative Party officials and reformist or radical candidates, whether belonging to the Party or not. For the first time in decades, this political competition aroused public curiosity and participation. However, the representation in the People's Congress did not accurately reflect the election

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<sup>7</sup> This measure was initially received with some diffidence, because in the traditional dogmatic conception, the Party and the state were supposed to be separated. In reality, of course, this was never the case and the state apparatus was always tightly controlled by the Party apparatus.

<sup>8</sup> 20% of Party secretaries at the provincial or republican level failed to get a majority vote. *Pravda*, 16-10-89, p.2.

<sup>9</sup> *Pravda*, 13-7-90, p.1. Gorbachev did however manage to use the results of the elections to get rid of some conservative elements in Central Committee. Between february and April 1989, the number of CC members fell from 303 to 251. *Argumenty i fakty*, 9-2-90, p.6.

outcome since 750 of the 2250 mandates were reserved to Party officials and members of social organizations<sup>10</sup>.

The First Congress of People's deputies in June 1989 was directly transmitted on radio and television, in the spirit of glasnost, and the debates were very heavily followed by the population. In Congress itself, the parliamentary logic started to unravel and a polarization process started to develop with the emergence of a radical, a conservative, and a centrist tendency. Radicals began to organize by forming in september 1989 the "Interregional group", counting 393 out of 2.250 deputies in People's Congress.<sup>11</sup>

It appeared at this First Congress that the centre of gravity of political power in the Soviet Union was slowly shifting from the Congress and the Central Committee of the Communist Party to the Congress of People's deputies and to the Supreme Soviet. Nevertheless, it also appeared clearly at the July 1989 session of Congress that only a minority was in favor of radical economic reform, the conservative or moderate conservative tendency being still in majority. As a consequence, even though political institutions started to shift towards more democracy, the political constraints to further economic reform appeared quite clearly in Congress. This led to a heated debate among intellectuals in the summer of 1989 concerning the importance of democracy in the sequencing of transition. Leading intellectuals like Migranian (1989) and Kliamkin (1989) advocated the need for strong presidential powers to go ahead with economic reform. Kliamkin argued very clearly in *Moskovskie Novosti* that Congress would not vote for the transition to the market whereas Migranian, in *Novyi Mir* argued that all historically known transitions towards the market economy did not proceed under democratic conditions. The importance of conservative and moderate conservative forces in Congress was confirmed at the December 1989 session with the approval of the so-called Ryzhkov plan,<sup>12</sup> an emasculated version of the Abalkin plan that had been published earlier in october and that was advocating a moderate and gradual transition towards the market economy<sup>13</sup>. One of the components of the Ryzhkov plan consisted in

<sup>10</sup> For the official report on the elections to Congress, see *Izvestiia*, 26-5-89, pp. 2-4.

<sup>11</sup> *Pravda*, 31-7-89, p. 2.

<sup>12</sup> *Izvestiia*, 21-12-1989.

<sup>13</sup> *Ekonomicheskaiia Gazeta*, n° 43 1989, pp. 4-7. The Abalkin plan represented a major advance in the reform concept compared to the 1987 reform, as it clearly defined the introduction of the market as a goal, and as it recognized the pluralism of different forms of property, though the word private property is not explicitly mentioned in the plan. The Abalkin plan appeared non credible concerning stabilization as it advocated moderate



hoping to rely on the conversion of the military industry to increase the supply of consumer goods. Increasing supply has always been the typical reflex of central planners reacting to shortage and these increases in supply were never effective in eliminating shortage, precisely because they were triggered through the central plans, i.e. one of the main shortage-creating mechanisms (see Roland, 1990b).

As it became clear that the Congress and the Supreme Soviet elected in 1989 would not support a consistent radical plan towards the market, the political composition of Congress started reflecting less and less the underlying balance of power inside the population. Indeed, in the wake of the autumn 1989 revolutions in Eastern Europe, the process of radicalization started to accelerate inside the population. The press of early 1990 is full of reports on countrywide protest movements, fuelled by local scandals and leading to the resignation of Party officials. This change in the political atmosphere inside the population was reflected in the elections that took place at the levels of republics and local soviets.<sup>14</sup> One of the major episodes of this election was the election of the new Parliament of the RSFSR and the subsequent election of B. Eltsin as the president of the Russian republic.<sup>15</sup> These elections reflected a shift towards radicalism inside the population. Candidates of the "Interregional group" obtained a majority in the new city Soviets of Moscow and Leningrad<sup>16</sup>. Nearly all its candidates were elected deputies in the new Russian People's Congress. By contrast, one of the major surprises of this election was the defeat of slavophile right wing Russian nationalists. In Moscow and Leningrad, the "patriotic associations" did not even manage to have a single candidate elected in Russian Parliament and complained that their defeat was the result of electoral fraud against them<sup>17</sup>. Gorbachev's failed attempts to block the election of B. Eltsin by

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incomes and price policy in order to correct the macroeconomic imbalances that had developed in the economy since 1985. The Ryzhkov plan, however, only adopted the conservative parts of the Abalkin plan, delaying plans for more radical economic reform to the distant future.

<sup>14</sup> Opinion surveys prior to the elections had shown a shift towards radicalism. A poll of 4,000 urban and rural residents conducted by the Academy of Social Sciences in the Donetsk province, the Tatar autonomous republic and the non black earth-zone of the Russian republic showed that 40% of respondents believed that *all* Soviet local and district members should be replaced. *Izvestiia*, 30-1-90, p.2.

<sup>15</sup> 94% of the 1059 deputies in Russian People's Congress were elected for the first time. Compared to traditional Soviet institutions, the % of workers is very low : 5.6% of all deputies. Only 6 rank and file farmers were elected. *Pravda*, 17-5-90, p. 1.

<sup>16</sup> In the new Leningrad city Soviet, only 20% of the elected deputies stood behind the CPSU platform, i.e. the Gorbachev political line. *Pravda*, 12-4-90, p. 1.

<sup>17</sup> For more details, see *Izvestiia*, 6-4-90, p.1,3.

supporting Vlasov, the former head of the Council of Ministers of the Russian republic, was also a sign that he was losing the political initiative<sup>18</sup>. A few weeks earlier in February 1989, Gorbachev succeeded in having the Central Committee accept the suppression of article 6 of the Constitution stipulating the leading role of the communist Party. Though this was a major success for democracy, it also was clear that this was not a political initiative of Gorbachev but a result of a radical campaign with the notable participation of late academician A. Sakharov.

What we want to emphasize here is that the so-called rise of the Russian republic in the political debate actually reflected less a conflict between centralized versus decentralized visions of government than the shift in balance of power towards reform that had occurred between the elections of 1989 and 1990. In the Russian Parliament, there is a stronger base for a push towards more radical moves to the market. A similar phenomenon explains the emergence of non-communist local government in Moscow and Leningrad. We will come back later to the directly political dimension of nationalism when discussing the problem of the dislocation of the Soviet Union.

This movement of radicalization inside the population found its base outside the communist party. Losing more and more its former legitimacy and power base, the Party was increasingly being perceived as a bastion of conservatism.<sup>19</sup> It is precisely inside the Party that the conservative reaction started taking place, with the first Congress of the Russian CP taking place shortly after the decision of German reunification that presumably created problems between Gorbachev and the Army<sup>20</sup>. This rise of political conservatism inside the Russian communist party, expressing itself through the election of I. Polozkov, a well known conservative, as the leader of the Russian Party. This conservative backlash inside the communist Party came

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<sup>18</sup> In a first round of votes on May 26, Eltsin received 497 votes against 473 for Polozkov and 32 for Morokin. Morokin retired and Eltsin got 503 votes against 458 for Polozkov. This was not enough to get a majority and on May 29, a new election took place and Eltsin got 535 votes against 467 for Vlasov and 11 for Tsoi. *Izvestiia*, 29-5-90, p.1.

<sup>19</sup> Opinion surveys held in June 1989 showed that one third of the population and one fourth of Party members doubted that the Party would be able to restructure. *Pravda*, 16-10-89, p.2.

<sup>20</sup> At the Russian Congress, conservative army officials voiced very loudly their protest against the change in foreign policy. Particularly aggressive was a speech of general Makashov, troop commander of the Volga-Urals Military district who accused the Soviet leaders of disarming while the West was acting as it was preparing an aggression against the Soviet Union. *Pravda*, 20-6-1990, p.1. A reply to this speech was published in *Izvestiia*, 20-6-p.1.

as a threat to the Congress of the Soviet CP. The Congress had been convened earlier than planned, when Gorbachev succeeded in suppressing the monopoly of the Communist Party, expressed in article 6 and 7 of the Constitution<sup>21</sup>. The expectation at that time was that the shift towards radicalism might succeed in transforming the communist party in a modern social democratic formation, eliminating the conservatives, an operation similar to the transformation of the communist party in Hungary. The conservative offensive at the Congress did not succeed in pushing through a conservative platform. It however became clear that, as a leader of the Communist Party, Gorbachev could at best refrain conservative Party opposition at the price of slowing down the process of transition.

The increasingly defensive position of Gorbachev towards the conservative camp widened the political field available for the proponents of more radical constituencies. Taking advantage of a) his position of Russian president in the more radical Russian Congress and of b) the increased discredit of the Communist Party, B. Eltsin made the courageous and risky move of leaving the Party at the end of the Congress.

This new situation changed the form taken by the conflict between conservative and reformist forces.

On one hand, Gorbachev's position towards the conservatives was strongly weakened because of his strong decline in popularity, as shown for example in opinion polls<sup>22</sup>, Eltsin becoming the leader of the reformist forces and enjoying considerable support inside the population. On the other hand, these more radical forces lacked the infrastructure of a united political formation and of organized support inside the state administration, Eltsin's position as president of Russia being less a position of power than of opposition. In this political stalemate, in order to "weigh" more in the bargaining with Eltsin, Gorbachev had to seek the support of the apparatus and thus lean more in the direction of the moderate conservatives who were ready to accept his leadership but wanted restoration of administrative order.

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<sup>21</sup> Initially planned for early 1991, a central Committee plenum decision advanced it to October 1990. *Pravda*, 20-9-89, p.1. The March 1990 plenum then decided to advance it to June. *Pravda*, 12-3-90, p.1.

<sup>22</sup> In 1989, opinion surveys still showed massive approval when Gorbachev was elected president of the Supreme Soviet. See *Pravda*, 26-6-89, p.3. An opinion poll conducted in July 90 showed a decline in popularity of Gorbachev as well as a clear loss of public confidence in the Party. Only 18% of the respondents were satisfied by Gorbachev's political report to the Congress. 64% agreed with the growing criticisms on Gorbachev and 75% with the growing criticisms of the government. Only 25% thought that the 28th Congress would influence the future of the country. See *Moskovskie Novosti*, n° 30 1990 for more details.

This conservative backlash became increasingly clear with the rejection of the Shatalin plan. Despite the criticisms one may formulate vis-à-vis the latter, *inter alia* in terms of the credibility of its stabilization measures, it was the first economic plan advocating unambiguously large-scale privatization of the economy and its rejection appeared clearly as a conservative victory.

This negative balance of power change had cumulative effects and the next months, until April 1991, can be viewed as a period of backlash with conservative agenda-making under prime minister Pavlov and the new team around Gorbachev, the perspective of a military coup being constantly possible.

The situation became partly unblocked when, after the failure of conservative stabilization measures<sup>23</sup>, an alliance was forged between Eltsin and Gorbachev to elaborate a new Union Treaty that would considerably weaken the position of the Union vis-à-vis the republics. In reality, this was a major concession of Gorbachev towards Eltsin, since the latter had always opposed centrifugal movements in the reform process, but their alliance reinforced the position of the reformist camp, and allowed the latter to regain initiative on the political agenda. The direct election of B. Eltsin as Russian president in June 1991, and his overwhelming success with more than 67% of the votes, proved a crucial success for democracy and a defeat for conservative forces who had previously attempted to oust Eltsin from his post.

The decisive advance in the democratization process came with the failure of the conservative putsch in August that abruptly ended communist rule in a similar way as in the other postsocialist countries. This failed putsch represents a historical chance for the future.

The main advantage of the new situation is that it provides *legitimacy* to the new non-communist leaders in the different republics. As in Poland, exactly two years ago, this major advance towards democracy entails a dynamic balance of power change, allowing speed in the implementation of further transition measures.

In the case of the former Soviet Union, this positive aspect is somewhat overshadowed by negative aspects that could reveal fatal. To recall, in the

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<sup>23</sup> These were the February currency reform, i.e., the withdrawal of the 500 Ruble banknotes, and the April administrative price increases. These measures were conservative because they were not accompanied by a price liberalization and were meant essentially to stabilize the financial situation in the context of continued central planning. The currency reform was not implemented as initially planned, because local authorities fully compensated all citizens turning in their banknotes, and the price reform had no noticeable dishoarding effect.

sequencing framework proposed in section 1, one of the main advantages of the democratization process is that it provides a stable and predictable framework. Nothing is less true here. First of all, the democratic forces are not very united, and were not really ready to seize power. One may easily conjecture that the failure of the August putsch was more due to the extreme incompetence, division and fear of the putschists than to the organizational strength of the democratic resistance. Second, the numerous conflicts of authority between local and higher level organs makes the legal framework increasingly unclear. Third, the unbridled development of nationalist forces, after the generalized declarations of independence, provides ground for the most dangerous process of polarization, increasing the risk that continued economic crisis will degenerate in bloody ethnic conflicts.

## 2. PRIVATIZATION.

As argued in section 1, the existence of a private sector of a minimum size constitutes a necessary step in transition before heading towards more radical moves. A similar idea was expressed by academician Bogomolov on the eve of the June 1987 plenum<sup>24</sup>. At that time, Bogomolov emphasized that those countries that were at that time the most advanced in economic reform (China and Hungary) had proceeded to decollectivise agriculture and to promote a private sector and small enterprises as well as calling upon foreign capital for joint ventures and foreign direct investment.

From that point of view, the introduction of the so-called cooperatives constitutes one of the few visible steps towards the introduction of the market. The decision to allow the establishment of cooperatives came nearly unnoticed when it was decided in november 1986. In a first stage, people were not allowed to leave their jobs in the state sector to work in cooperatives. The latter were only allowed as an activity for pensioners, the non active part of the population and for workers after their hours. This restriction was however relaxed. In May 1988 a law on cooperatives was voted.

The most striking feature about the introduction of cooperatives was the rapid growth of this sector despite a very hostile political and social environment. In 1988, the ministry of Finance decided a prohibitive tax system on cooperatives with marginal tax rates of 90% for incomes above

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<sup>24</sup> *Ekonomicheskiiia gazeta*, n° 26 1987.

1500 R<sup>25</sup>. This measure was however withdrawn after public protest. Cooperatives however became rapidly unpopular inside the population. Complaints concerned the high prices for a relatively low quality the links of some cooperatives with the mafia and organized crime. There were also complaints that cooperatives bought consumer goods from the state sector to sell them at higher prices. Conservative politicians started blaming the cooperatives for the growing shortage of consumer goods in the economy.

Measures against the cooperatives were adopted at different periods. Important restrictions on cooperative activities were decided by government in december 1988<sup>26</sup>. Price ceilings and prohibitive taxes were imposed in many cases on cooperatives and examples abound of restrictions and prohibitions decided by local authorities between december 1988 and April 1990.

Despite these negative measures, the cooperative movement has not declined and is still growing. In June 1991 12,4 million people were working in the cooperative and individual sector, i.e. 9,1% of the 135 million people employed in the Soviet economy<sup>27</sup>. In the russian republic, the corresponding figures are 4,8 million people, i.e. 6,7% of 71,9 million working people<sup>28</sup>.

Cooperatives which are in most cases hiding private enterprises thrive and start to create a new entrepreneurial class. The rapidity with which new entrepreneurs take business opportunities in a hostile and semi-legal environment is very striking and seems to refute the allegations according to which the russian culture is viscerally incompatible with market institutions. The Moscow commodity exchange is gradually replacing the increasingly paralyzed Gosstab state supply system and private commercial banks are growing like mushrooms to finance these commodity exchange operations<sup>29</sup>.

Joint ventures have also developed in two years time. Allowed since early 1987 with legislation becoming increasingly favorable to western investors, registration of joint ventures started to accelerate from May 1987 to July 1989, 680 joint ventures being created with a capitalization of 2,1 billion

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<sup>25</sup> *Ogonëk*, n° 29 1988.

<sup>26</sup> *Izvestiia*, 31-12-88, p.2.

<sup>27</sup> *Ekonomika i zhizn'*, n° 30 1991.

<sup>28</sup> *Ekonomika i zhizn'*, n° 31 1991.

<sup>29</sup> Given the great economic uncertainty, credit is limited to short term loans to provide liquidity for commodity exchange operations. No long term investment credit is being provided by the new private banks.

rubles.<sup>30</sup> The rhythm of registration then started to settle at an average of 285 per quarter. As yet, less than a quarter of joint ventures seem however to be really operational, most of them being small, undercapitalized and concentrated on supplying services rather than manufactured output. Employment in joint ventures remains small and does not exceed 200.000 people, or 0,2% of the workforce in the Soviet Union<sup>31</sup>.

Despite negative popular attitudes towards cooperatives, the overall attitude of the population towards private activity is changing at a fast pace in a positive direction. According to opinion surveys, in november 1989, 42% of the people still had a negative attitude towards private property against 31% in favor and 27% without opinion. In december 1990, negative attitudes had nearly halved with only 26%, against 44% in favor and 30% without opinion.<sup>32</sup>

The biggest failure concerning the introduction of a private sector is agriculture. Where decollectivisation proved to be a success story in China and in Hungary, measures such as the leasing of land (*arenda*) did not lead to a chinese-type of movement. On the contrary, the immobility of russian peasants is particularly striking and is somehow reminiscent of the 1861 emancipation from serfdom, the 19th century perestroika where serfdom was formally abolished but where the peasants did not receive the possibility of growing private and family exploitations. The April 1989 plenum of the CC to put ahead reform in agriculture also proved a failure, as a foul compromise was decided: *arenda* was to be understood as leasing inside the *kolkhoze*, and it was not clear whether the peasants had the right to leave the *kolkhoze*. The appointment of Ligachev as the politburo responsible for agriculture clearly did not provide the peasants a credible signal that irreversible changes were coming.<sup>33</sup>

The political change after August 1991 should be used to quickly decollectivise and privatize the land, by sharing it among peasants, either directly or through some voucher scheme, and abolishing all restrictions on buying and selling land. The central authorities in the republics should send inspectors in the countryside to monitor implementation of land privatization and help the peasants fight against the local party nomenklatura which still holds the reins of local power. New elections would probably be the best

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<sup>30</sup> *PlanEcon Report*, sept. 1 1989.

<sup>31</sup> *Ekonomika i zhizn*, n° 43 1991.

<sup>32</sup> *Voprosy Ekonomiki*, n° 6 1991, p. 112.

<sup>33</sup> See *Pravda*, 18-3-89, pp.1-2.

way to topple local despots, provided these elections are perceived by the farmers as a clear and credible signal for action in order to guarantee the regularity of the polls.

In order to be credible, privatization of the land must go together with the freedom of pricing and selling, i.e., with the establishment of a market for land.

### 3. LIBERALIZATION.

The objective of freeing prices and of going over to wholesale trade for means of production was already present in the 1987 June plenum decisions on economic reform. Immediately, a conservative counteroffensive on prices was started, presenting perestroika as a trick to increase prices and to lower the purchasing power of the population.

Conservative economist M. Popov (1987) launched an attack on hidden inflation presented as a consequence of the relaxation of plan discipline since the early reforms of the sixties.<sup>34</sup> The right wing populist *Nash Sovremennik* for example published an article of B. Kulikov(1988) that found a clear echo in the population. It equated price liberalization with administrative price increases and called for public mobilization against price reform in the spirit of the mobilization against the diversion of the siberian rivers.

This conservative campaign yielded results. G. Popov, the radical economist reported in the press on the hostility of a majority of delegates to the 19th Party conference to any increases in retail prices and argued in his turn against price reform<sup>35</sup>. Shmelev (1989) and Latsis, other radical economists noted in the beginning of 1989 that it would be politically impossible to get through any reform in retail prices, in view of public hostility and of the decreased possibilities of compensation due to the increase in the budget deficit.<sup>36</sup>

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<sup>34</sup> According to this economist, not only should socialism defend price stability, but it should aim for their planned reduction, in proportion to increases in labor productivity. Imposing price decreases to enterprises should force enterprises to innovate and to reduce costs, as it was the case in the thirties and the fifties according to Popov.

<sup>35</sup> *Ogoniok*, n° 33 1988.

<sup>36</sup> Interview of O. Latsis in *Liternaturnaia Gazeta*, 25-1-89. The aggressive tone of the interviewer was very characteristic of public attitude. *Liternaturnaia Gazeta*, then not yet in the hands of the slavophiles, boasted of having campaigned all along 1988 against any retail price increase.



In december 1988, price reform was delayed and measures were decided to strengthen price control.<sup>37</sup> The issue of price increases became a focal point of conservative opposition. At the March 1989 plenum, it was announced that no retail price changes would take place in the next two to three years.<sup>38</sup>

After the big bang of January 1990 in Poland where most prices were liberalized overnight, many Soviet economists became enthusiast for the polish shock therapy. This enthusiasm might have been the source of a new move of the Ryzhkov government to go ahead with price reforms.<sup>39</sup> Presented as a gradual strategy to introduce the market, the polish-type reform seeming politically impossible to implement because of the much weaker popular support of the Soviet government<sup>40</sup>, the plan proposed among others a 100% increase of retail prices for food with 70% social compensation. A threefold increase in the price of bread was to occur, starting from July 1st<sup>41</sup>. The maneuver of Ryzhkov, announcing in May price increases several months ahead seemed a clumsy move as it created a hoarding panic in the population<sup>42</sup>. The Ryzhkov proposal was withdrawn in major part<sup>43</sup>, not because it was not radical enough, a "shock without therapy" as stated by P. Bunich<sup>44</sup>, but mostly because of public opposition towards price increase.

The issue of price increases had become a focal point of conservative opposition against perestroika. Given this focalization and given the poverty of important parts of the population, price liberalization had been until recently blocked by political constraints.

Events in 1991 however strongly changed the balance of power in that respect. First of all, the conservative methods have been tried and failed. Conservative forces had since several years requested a stalinist-type currency reform to "confiscate" the revenues of the parallel economy. The currency reform of the conservative Pavlov government proved to be an

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<sup>37</sup> *Pravda*, 6-1-90, p.1.

<sup>38</sup> *Pravda*, 13-3-89, p.2.

<sup>39</sup> See for example the interview of A. Orlov, a well-known economist and government official, expressing positive views on the polish shock therapy. *Izvestiia*, 3-4-90, p.1.

<sup>40</sup> Remarks made by L. Abalkin. *Izvestiia*, 10-4-90.

<sup>41</sup> *Pravda*, 25-5-90, pp. 1-4.

<sup>42</sup> *Izvestiia*, 26-5-90, pp. 1-2.

<sup>43</sup> The supreme Soviet adopted a resolution on a move towards the market (*Izvestiia*, 14-6-90, p.2) but rejected the proposed price increases. *Izvestiia*, 15-6-90, p. 1, 3.

<sup>44</sup> *Izvestiia*, 26-5-90.

organizational fiasco. Ironically, it is the same conservative government who decreed the April administrative price increases, precisely the focal point of previous conservative opposition. This shattered the last illusions of a possible return to former price stability under a return to authoritarian rule and destroyed the credibility of a conservative program.<sup>45</sup> The defense of price controls appears increasingly meaningless under the continued dislocation of the planning system, where accelerating inflation cannot be stopped anyway. However, the increasing distortions due to the remaining price controls plead for a quick move to price liberalization and macroeconomic stabilization. Finally, the implosion of communist rule gives the new leaders the needed legitimacy to go ahead with radical measures that were resisted by the conservative camp.

### III. ASSESSMENT OF THE CURRENT SITUATION AND URGENT ISSUES.

Turning back to the framework of section 1, how can we assess the transition path in the Soviet Union since 1985?

First, where do we stand, according to this framework? As seen in section 2, the first two steps of the four-phase sequencing, democratization and privatization, have been initiated. The next step ahead is price liberalisation, which we think is now politically possible and desirable. We will come back below to the political economic conditions of its implementation. As was the case in Poland in 1990, it is yet too soon to start with the fourth phase, that of restructuring. We will discuss below the consequences of this limitation, *inter alia* concerning the probability of success of stabilization programs.

Second, what lessons can be drawn from the last 5 years with respect to this framework? The events do not seem to have refuted the political economy view of sequencing. The main forces of resistance to the August putsch were those who were to lose from the elimination of democracy and the private sector. The democratic intelligentsia and associations of businessmen, brokers and commodity exchange workers proved particularly active to defend the White house. Constituencies had thus been created that did not exist a few years earlier, and these forces proved effective enough, in front of a divided and incompetent putschist alliance. A return to the past is

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<sup>45</sup> The day of the putsch, there was a rumour in Moscow that the putschists decreed a 300% reduction in prices.

now totally excluded. Irreversible moves have been achieved, and this is a major merit of perestroika. The most difficult steps (price liberalization, and especially restructuring) are however clearly ahead.

Third, how can one understand the failure of Gorbachev's reform strategy, despite the achieved irreversibility?

Gorbachev's strategy was one of gradual and pacific transition towards democracy and towards the market economy, inside the bounds of the Soviet Union. Starting the transition process from his position of leader of the Communist Party, he was inevitably led to oppose all processes undermining this position. Which politician would push forward a program leading him consciously to loose power? His strategy was thus necessarily biased towards compromise and gradual moves. By definition, when you are "above", you can only reform from above.

A first factor undermining his position is naturally the emergence of centrifugal forces in the republics. There was, since the beginning, on his part the realization that nationalist conflicts are bound to emerge on the basis of a disintegration of the power of the Union. No territorial division could settle ethnic conflicts, given the existence of important ethnic minorities all over the Soviet territory. Hence the need for a strong centralized power to bring about and to implement the transition towards the market. If feasible, such a pacific strategy is clearly more desirable. *Ex post*, one also understands why forms of russian "containment" were necessary to obtain relative peace inside the Union, through the absence of specifically russian institutions, the absence of a russian Party, special subsidies from Russia to the republics, etc. The disintegration of the Soviet Union thus constitutes a clear failure of this strategy.

A second factor was the development of democratic and radical forces outside and against the Party. In the first years of *glasnost'*, he could play these forces against the conservatives inside the Party, to push forward the agenda of reform. When however these forces, unconstrained by the need to assume power inside the communist party, started gathering strength and popularity and challenged his position as a leader of the reform camp, his position became always more uncomfortable, especially since he did not succeed in isolating conservative forces inside the Party fast enough, compared to the political momentum inside the population. This also constituted a failure for Gorbachev and left a political vacuum that was taken over by Eltsin.

The strategy of Eltsin tended to support all nationalist movements inside the republics and all conflicts with the centre to weaken the power position of Gorbachev and to strengthen the power of the opposition. Starting from a position of opposition, it was in his interest to coalize in the Soviet Congress with all opposition forces, including independentist forces. The pro-republican alliance between Russia and the other republics has been set up for political reasons. The interregional group regrouping radicals from Russia and independists or autonomist politicians from the the other republics had the aim of constituting a parliamentary group in Congress to be able to weigh more in the political decision-making process. It seemed however straightforward that, if such an alliance would come to power, thus instituting a looser confederal structure, then, in case of conflicts in outside republics touching upon russian interests, Russia would impose its interest and it has the military and economic weapons to do so. With the breakdown of the Soviet Union after the failed putsch, and especially after the declaration of independence in the Ukraine, it is clear that this asymmetry between Russia and the other republics will dominate their bilateral relationships, confronting directly conflicting national interests, without any indirect mediation of a federative structure, based on other principles than nationalism.

Was Gorbachev's strategy necessarily doomed to fail? Despite the evidence, it is not sure whether a pacific and gradual transition could not have succeeded. As argued above, there does not seem to have been a major sequencing error. Gorbachev's failure is rather best explained as a *speed failure*. He failed to use the momentum created by the progress in democratization and in the growth of private activity to pass the Rubicon of price liberalization. As shown above, conservative opposition was too strong to enable such a decision to be taken. This could have been coped with if the economy had continued along its brezhnevian path of relative macroeconomic equilibrium with stagnating growth. After all, in China and Hungary, the gradual growth of a private sector has allowed to build up constituencies preparing these economies to cope much better with the requests of a private market economy, once the necessary political changes occur or will occur. However, quite the contrary happened in the Soviet Union, and Gorbachev is responsible for a huge macroeconomic mismanagement for which the Soviet people rightly blame him.

The causes of this growing disequilibrium are known. It is the early *uskorenje* or acceleration campaign, increasing investment expenses with the

aim of modernizing the economy and the machine-building sector. All sorts of social expenses were significantly increased. The early move towards decentralization of economic management resulted in the removal of wage controls leading, in a situation of labor shortage compounded by enterprise soft budget constraints, to wage increases well above productivity growth. On the other hand, this decentralization also resulted in a loss of tax revenues, enterprises paying less taxes than before. All these inflationary measures led to an increase in overall shortages, as prices remained more or less frozen. Prices in cooperatives being more or less the only free prices in the economy, the inflationary measures led to a high price differential with the state sector, thereby increasing the political tensions on the issue of cooperatives.

The higher the inflationary disequilibrium, the more urgent it became to introduce the price mechanism. Indeed, the loss of control over macroeconomic equilibrium reinforced the dislocation of the command system itself. In the absence of market-clearing prices, shortages tend to create important horizontal conflicts blocking resource allocation decisions (Roland, 1990c). These conflicts were traditionally settled in last resort by the planning authorities. The latter have however become too weak to play this mediating role any longer. The only legitimate authorities arising are local and republican ones who dispute the allocative decisions of the Centre and protest by stopping to deliver planned output or by reducing these deliveries, thereby making shortages even more acute and reinforcing this implosive mechanism. This tendency towards local protectionism and towards an implosion of exchanges and of production has highly deleterious effects on the economy and would tend to exacerbate horizontal conflicts between republics, regions, etc. Gorbachev's macroeconomic policies thus led to the necessity either of accelerating a decision of price liberalization or of strengthening state controls. Being unable to go ahead with the former or the latter, he let the situation deteriorate which necessarily led to increased polarisation between conservative and reformist forces, increased nationalist polarisation, eventually undermining his own position, and losing all the popular support he had gained with *glasnost*'.

One is however entitled to doubt whether macroeconomic loss of control and disintegration of the Soviet Union were evitable at all. Arguing counterfactually is never easy, and actual events tend to appear inevitable, with the logic of hindsight. Nevertheless, the above reasoning tends to show that early macroeconomic mismanagement such as *uskorenje* was not an

"endogenous" result of perestroika, but a plain policy error. Even though the emergence of nationalist pressures was, to a large extent inevitable, it was and is still reinforced by macroeconomic mismanagement. Moreover, in line with the agenda-setter hypothesis of section 1, keeping control over the political agenda is crucial in circumstances of such great transformations, and speed failures lead precisely to loss of agenda control. Applied to the nationalist issue, this implies two things. First of all, early initiatives for constitutional reform could have been a way of keeping the initiative. Second, if there had not been a speed failure, the flow of transition measures and economic change would have been impressive enough to keep the nationalist issue partially off the political agenda. In politics as in war, keeping the initiative yields strategic advantages.

Now that the Soviet Union has disintegrated and that communist rule has been eliminated, what are the urgent issues, what are the political constraints, and what role should the West play in the new situation?

The biggest risk facing the former Soviet Union in the near future is the repetition of the CMEA implosion, leading to a breakdown of trade and to a catastrophic depression.

## 1. PRICE LIBERALIZATION AND MACROECONOMIC STABILIZATION.

The disintegration of the Union makes price liberalization even more urgent than ever. The introduction of free market prices lifts all suspicions and accusations concerning who is subsidizing whom. Quarrels on the terms of trade otherwise lead very quickly to a retention of exports on both sides. As last year's experience with the breakdown of the CMEA has shown, price liberalization is a necessary, though not sufficient condition to avoid trade disruption and autarkic implosion. A sustainable international payment mechanism is needed.

We assume that all independent republics will want to establish their own currency. However anachronistic it may seem to West Europeans, the establishment of national currencies will enjoy popular support, as they will represent a symbol of break with the communist past in Russia and of the new sovereignty in the other republics. The establishment of national currencies can be a good point of departure for establishing macroeconomic stability.

Even in a favorable political environment, price liberalization and macroeconomic stabilization must go together with social measures avoiding that important parts of the population fall below the poverty level. Different scenarios try to cope with the problem of the monetary overhang. In the appendix, we briefly review them.

The next question is how to maintain macroeconomic stability. The first priority is having balanced budgets. This is however not sufficient, and the experience of Poland and Yugoslavia gives ground for some scepticism concerning the possibility of keeping inflation at a low level, even when budgets are formally balanced. The big difficulty is how to keep monetary policy under control, when capital markets are not developed and as long as the phase of restructuring has not been initiated. Indeed, as shown by the experience of Poland and Yugoslavia, one of the main inflation-creating mechanisms is spontaneous interenterprise credit. In case of a tight monetary policy, when enterprises are refused access to credit, they simply stop paying their suppliers, thereby generating a chain of virtual bankruptcies, which amounts however to wild credit formation, as deliveries continue to take place, and nobody insists on having its debts repaid. In that context, higher interest rates lead only to higher prices, as credit demand is not curbed. The only way to stop this uncontrolled creation of money is to implement bankruptcy rules. However, not only is this politically difficult, in the absence of a capital market, since the enforced exits will not be compensated by appropriate entries, but the chain of interenterprise credit threatens, in case of a local bankruptcy, to lead to generalized bankruptcies and bank kraches. Income policies are thus certainly needed to compensate for the difficulty of implementing tight monetary policies. However, one must acknowledge the possibility that, even though inflationary expectations must be broken through appropriate stabilization measures, the "natural" rate of inflation might remain high, in the absence of higher exit and entry rates in the economy, which will take a certain amount of time. In other words, as long as the enforcement of bankruptcies in obsolete industries is subject to political constraints, subsidies, in an open fiscal form or in an indirect form through wild credit, will have to keep these enterprises alive, thereby representing a serious obstacle to breaking inflation. Only when the final stage of transition has been completed, i.e. that of restructuring, will full stabilization be achievable.

Note also that, even in a context of free prices, the subsidizing of loss-making industries introduces a distortion in relative prices.

Note finally that, even when political constraints are less pregnant, immediate and full bankruptcies of obsolete industries may not be optimal since a too heavy decline in output reduces the value of the privatizable enterprises, in a situation where macroeconomic information is one of the only indicators to estimate this value.

In any event, there is a low probability that, even when hyperinflation is broken, inflation may be brought down under two digit levels. Moreover, there are chances that the inflation rate will differ across republics. It is thus of extreme importance to examine what exchange rate regime will prevail between the newly established national currencies. A repetition of the CMEA disaster of 1991 would represent the biggest imaginable negative output shock, given the interdependence and specialization that has prevailed so long. We will not discuss here what the exchange rate regime should be, but raise a few questions concerning the relationships between the republics in the future.

## 2. THE FUTURE ECONOMIC RELATIONS BETWEEN THE REPUBLICS.

Is the disintegration of the Soviet Union going to lead to a looser confederation of states, that might resemble in any way to the European Community?

Though the idea of a new confederation of states giving itself institutions similar to those of the EEC, based on the subsidiarity concept, might seem very tempting one should note at least three differences between european unification and the prospects for such a new Soviet confederation.

First of all, compared to the EEC, the Soviet Union finds itself in a process of disintegration, not of integration. The continued conflict between republics and nationalities will tend to divide and not to unite them. The disadvantages of conflict and sovereignty are not yet experienced. As a consequence, the costs associated with national sovereignty in a disintegrated Union tend to be underestimated while the benefits of independence tend to be overestimated. Even when the costs of disintegration are clearly perceived, it is not clear at all why the process of disintegration should stop. Given the non-cooperative nature of conflictual relations between republics, and insofar as this non cooperative relation has a prisoners' dilemma structure, it is not clear why disintegration should stop



unless some sort of mechanism is put in place that creates confidence and institutes more cooperative attitudes.

Second, compared to the EEC, the costs of blocked decisions are greater. Indeed, as often happens in the EEC, decisions may be blocked or delayed because no consensual agreement on a given decision can be agreed upon. This is partly a consequence of the loose confederal institutions requiring such a consensual agreement, on a symmetric basis between the partners. However, when decisions are blocked or delayed, no major economic catastrophe ensues inside the EEC. The former Soviet Union on the contrary finds itself in the middle of the process of the transition towards the market economy. Here the costs of blocked decisions are greater because institutionally, the economy is in a highly unstable situation between two opposed economic systems.

Third, compared to the EEC, blocked decisions in a new confederal Union are unlikely to appear, because of the asymmetry between them, and the dominance of Russia. Therefore, the republican governments will be highly suspicious towards any form of coordination, whereas the absence of coordination might lead to disastrous results.

Let us just give an example. Imagine that an EMS type system is built between the different republics with fixed exchange rates, and bilateral agreements to revise the parities. Assume that Russia has a higher inflation rate than the Ukraine, thus more than offsetting Russia's current account surplus with the Ukraine. Assume moreover that Russia is unwilling to devalue vis-à-vis the Ukrainian currency. Russia will run a current account deficit vis-à-vis the Ukraine, but this means increased exports from the Ukraine to Russia. This might not be welcomed in a public opinion facing the harshness of transition in the Ukraine. Moreover, Russia could later default on its debt vis-à-vis the Ukraine. Monetary cooperation on a free basis is therefore not very likely. In the case of floating exchange rates, the different parties would probably have incentive either to appreciate or depreciate their currency, depending on their policy objectives. In the absence of cooperation, "beggar thy neighbor" exchange rate policies are highly likely, exacerbating nationalist conflicts.

This was just an example of a more general phenomenon. The different republics will all have heavy transition costs to bear and each republic's share in the overall transition cost is not easily identifiable. There will therefore be, precisely as in the Alesina-Drazen model, a big temptation to shift parts of one's own transition costs on other republics, thereby leading

to dangerous and sustained stalemate and prolonged delay in the implementation of reform programs.

## CONCLUSION.

Cooperation between the former republics is unlikely and absence of cooperation will probably lead to disastrous economic results. This conclusion is rather dismal, even though the argument was sketched very roughly. There is however a way out if western help for transition creates the necessary incentives for cooperation. Help should be at the same time *generous* and heavily *conditional*. In our view, this is perhaps the only way to create long term commitment for an institutional stability that is so necessary for the success of the transition period. Without going in any detail, we will sketch here the basic elements needed to help to create *credible commitment* for reform.

The West should not insist on any particular institutional agreement between the republics, but it should insist that any feasible agreement accepted by the parties, be it concerning trade, exchange rate regimes, fiscal cooperation, etc. should remain stable, otherwise all western help should be withdrawn.

Transition programs should be elaborated in collaboration with the international organizations, and a consensus should be reached on the given policy. An international consensus on reform would give it a necessary dose of legitimacy. Any deviation from its implementation would lead to the withdrawal of help.

The West should insist that stabilization packages include far-reaching disarmament and cuts in military spending, and offer high sums of help for every dollar's worth less in the military budget.

It should offer all the technical assistance in legal, political, accounting, financial matters, etc., conditional on reaching an international consensus on reform.

It should offer important credit lines for international payment mechanisms between the former republics and CMEA countries, conditional on the continuation of domestic policy packages.

Western governments should offer special guarantees to private multinational banks wishing to establish themselves on domestic credit markets and to extend their operations to the new domestic private sector.

Politically, a special help should be devoted to Russia. Cruel and bloody as they are, existing civil wars between conflicting ethnic groups threaten less global world peace than fascist dictatorship or ethnic chaos involving Russia. Privileged ties with the West, generous conditional help, the encouragement of trade and investment, tie Russia to the West and create expectations of peace, growth and welfare in the whole region. On the contrary, it would be illusory to think that a prosperous central Europe could develop with civil wars raging at its eastern frontier.

The European Community has a privileged role to play in front of this new challenge. The attitude towards help in the former Soviet Union will be a test of the ability of the Community countries to cooperate on the definition of help packages.

## APPENDIX

## SCENARIOS FOR DEALING WITH THE MONETARY OVERHANG.

*1. A polish-type scenario.*

The first possibility is that of a polish-type liberalization, using nominal wages as an anchor in order to use the reduction in real wages as an anti-inflationary device. Under a polish-type scenario, there would be temporary high price increases, unmatched by an equivalent rise in nominal income. Though polish-type stabilization would reduce the purchasing power, and especially real consumption, it does however allow richer parts of the population endowed with savings, to smoothen their intertemporal consumption pattern. For those parts of the population, the real shock of stabilization would be less great, though the price increases would be equivalent to confiscation of large parts of their savings. However, the poorest parts would be hurt in real terms and would face a reduction in their real consumption level. Given the great poverty of large parts of the Soviet population, this scenario has evident dangers. One must however note here that a full and immediate liberalization is less dangerous than a half-way Pavlov-type stabilization with administrative price increases without market-clearing prices. Indeed, in the former case, the immediate vanishing of queues somehow mitigates the negative effects of the price increases, whereas in the latter case, we have queues and higher prices.

*2. Liberalization with limited indexation.*

It might however be possible to cushion off a polish-type stabilization through some forms of compensation. One such form might be an indexation of incomes limited to the lowest incomes. Indexation would have to be very limited so as to reduce its inflationary effects. There is however one problem with indexation: as there is always some lag between the observed price increases and the income indexation, indexation might prove to be a very poor tool for protecting real incomes, especially if rapid inflationary processes unleash.

### 3. Liberalization with limited rationing.

Given the uncertainties of indexation, it might be wiser to guarantee to the poorest parts of the population a minimum consumption level in kind. This is the idea underlying the egalitarian rationing schemes set up or proposed by economists like G. Popov<sup>46</sup> or V. Makarov, head of the TSEMI(1989, 1990). Citizens would receive coupons guaranteeing them a minimum amount of basic foodstuff and commodities. Apart from this minimum consumption basket, all prices would be liberalized. A major advantage of this type of scheme is its egalitarian character that might buy popular acceptance of price liberalization.

Rationing schemes through coupons are however in general allocatively inefficient. Some efficiency should therefore be obtained by introducing a limited exchangeability of these coupons, as proposed by these economists<sup>47</sup>.

A more serious disadvantage of this type of rationing scheme is that it needs a huge bureaucracy in order to manage this system of distribution. Centralized monitoring is indeed necessary to ensure that the given goods are produced and distributed as planned. The danger is that this might lead to tendencies to recentralize and give back more power to the bureaucracy, leading to a restoration of some form of traditional central planning. This danger might not be so great if rationing concerns only a small part of GNP. This is however not the case in the former USSR where providing a minimum consumption level to all citizens through rationing would need a mobilization of a majority of the resources available for consumption.

Besides the great danger of restoration of central planning, it might also be politically very divisive. The extent of what should be rationed would certainly be liable to great political debate, and this debate would be unnecessarily divisive, as the goals of efficiency and distributional justice would appear directly antagonical. An extension of rationing would appear as egalitarian but inefficient, whereas a reduction of the extent of rationing would appear as promoting efficiency but as inequalitarian.

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<sup>46</sup> In his electoral campaigns since 1989, Popov has argued that rationing is preferable to market-clearing price increases. See for example *Moskovskie Novosti*, n° 4 1989, p. 13.

<sup>47</sup> See the interview of G. Popov in *Izvestiia*, 28-6-90, p. 3.

#### 4. *A german-style currency reform.*

A fourth scenario for stabilization would be the introduction of a currency reform similar to the German currency reform of 1948. This could be implemented at the same time as the introduction of the national currencies. One variant of such a currency reform would be to freeze all savings of the population for a certain time, for example two years and to ask the population to hand over all their Ruble cash balances that would be converted for the new strong national currency. Such a currency reform would have several advantages. It would be rapid as the overnight creation of a shortage of money would rapidly bring the goods back on the shelves. There would be a general behaviour of dishoarding, and the flight from money would cease immediately, giving rise to a less pathological demand for money behaviour. It would immediately solve the stock dimension of the monetary overhang. Another advantage of a currency reform is that it would allow price liberalization to proceed in a non inflationary context. A currency reform might also gain some popular support. Indeed, it would be egalitarian as all citizens would receive an equal limited amount of the new rubles. On the other hand, it might appear partly as a blow against the mafia, since, provided effective controls, part of the illegal money would not be handed over. The extent to which the mafia would be hurt by such a currency reform would of course be necessarily limited as the part of its wealth held in money holdings is necessarily limited.

A disadvantage of a currency reform is its predatory character. To be effective, it must necessarily present itself as confiscatory of parts of the cash holdings of the population. Moreover, the confiscatory measures would hurt more the richer parts of the population, i.e. the capitalists of tomorrow, and this might have a discouraging effect. A measure that might be considered concerning frozen parts of savings is the indexation of the nominal interest rate on savings deposits. Pavlov has however made a try at a predatory currency reform in a conservative context and it would be politically unwise for the new governments to do something similar, even in a context of price liberalization, unless it is associated with the creation of a new national currency.

### *5. Emergency imports.*

An alternative measure that is often proposed to cushion the adverse effects of price liberalization is the resort to emergency imports, financed either through an increasing external deficit or, partly at least, through transfers from the international community.

We will just note here two drawbacks related to the issue of emergency imports. First of all, the Soviet economy is in such a state of disorganization, especially the transport and distribution network, that these imports might simply be wasted and not even reach the consumers who need them. These are the dismal lessons to be drawn from the increased import of consumer goods since the miners' strike of 1989.

Another potential drawback of emergency imports is that it might have adverse incentive effects on domestic producers, especially if these imports compete with domestic products. Under price liberalization, a large and rapid supply of foreign goods on the Soviet market would tend to depress relative prices for domestic substitutes, thereby reducing the incentive for local producers to increase supply.

### *6. Stabilization through privatization.*

Another alternative for getting rid of the monetary overhang is the massive sale of state assets: land, apartments, enterprises, etc.

One should note here that privatization serves essentially the goal of economic efficiency. It is perhaps not the best instrument to deal with the macroeconomic problem of stabilization. As privatization might serve the goal of stabilization only through the sale of state assets, i.e. not through give-away schemes<sup>48</sup>, this brings to the forefront the tricky issue of valuation: how is it possible to give a meaningful value to assets before liberalization? Partial giveaway schemes concerning housing and land might prove very popular, and might therefore be introduced together with harsher measures in order to extract the necessary popular acceptance for the latter.

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<sup>48</sup> One can argue that give-away schemes are fiscally equivalent to privatization through sales since future taxes can compensate for the current loss in sale proceeds. This might be intertemporally true, but stabilization requires current credible measures bringing about a drastic change in expectations formation.

### *7. Parallel currency schemes.*

Another proposal for stabilization is the introduction of a parallel currency, as advocated by N. Petrakov (1989) or Belkin, Medvedev and Nit (1989). This idea replicates somehow the currency reform of 1923-24 when the sovznak ruble was gradually replaced by the Chervonetz Ruble. This proposal is in a certain sense close to the proposal of a coupon scheme in the sense that the old Ruble would be used in the state sector and in those segments of the economy that still work according to the logic of central planning, whereas the directly convertible new currency would be used in all market transactions.

A major criticism made to the parallel currency scheme is that it would not be stable, and most probably, as in the Chervonetz episode, would rapidly end in the hyperinflationary demise of the old Ruble.

### *8. High real interest rates for savings and fiscal orthodoxy.*

One might argue, in view of all the proposals for getting rid of the monetary overhang, that there is no need for special policy measures to cope with the monetary overhang, and that appropriate changes in expectations and fiscal and monetary incentives, might be sufficient to get rid of that part of savings that is forced. The sale of financial assets, for example state bonds, at real interest rates that are high enough, possibly indexed, does divert part of intended consumption spending.

In the Soviet case, the following dimensions should however be considered. It is not certain that even indexed bonds issued by the state should reduce money demand significantly. First of all, even though indexed bonds may signal the commitment of the state to protect savings from inflation, it does not eliminate the possibility of default of state debt. Second, the decision to save depends partly on uncertainty concerning future income. Workers expecting to be unemployed in the future would save to smoothen their expected intertemporal income stream, as is observed in the former GDR. However, as long as unemployment does not appear as a credible prospect, and if workers expect that they will keep their guaranteed jobs in the state sector, then the precautionary motive for saving becomes less stronger. Third, accumulated frustration of consumers would most certainly lead to huge spending sprees in face of increased availability of consumer goods. Given this accumulated frustration, and given the



extremely low credibility any government will be likely to face, monetary and fiscal management does not seem to be sufficient to tackle the problem of the monetary overhang.

This lack of credibility implies that only immediate measures are effective such as a currency reform or a polish-type stabilization.

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