

Is Perestroika Possible? Advice from a U.S. Deregulator

Finanzmarkt und Portfolio Management
5 Jahrgang 1991 - Nr. 2

The natural effort of every individual to better his own condition, when suffered to exert itself with freedom and security, is so powerful a principle, that it is alone, and without any assistance, not only capable of carrying on the society to wealth and prosperity, but of surmounting a hundred impertinent obstructions with which the folly of human laws too often encumbers its operations.

-Adam Smith

The greatest ideals are not worth a brass farthing if they are not linked with people's interests.

-V. I. Lenin

Introduction

The topic of this paper—what the American experience with economic regulation and deregulation has to teach would-be Soviet economic reformers—will seem presumptuous to many Soviets and farfetched to many Americans. I thought so myself when the subject was first suggested to me. After all, regulation is unique to Western economies and has no direct counterpart in the Soviet Union. It describes a situation where the means of production are privately owned and managed but where certain business decisions—prices, investments, entry of new firms, wages and benefits, and so forth—are controlled or limited by the government. The economic and political dynamics of Western-style regulation would seem to be fundamentally different from those of a society where the government owns and manages everything.

I changed my mind, however, when I studied the debates over perestroika in the Soviet press and Congress of People's Deputies. Perestroika is so far an elite project of a few Soviet economists, intellectuals, and reform-minded politicians (some of them allies of President Gorbachev, others opponents who favor more sweeping reforms than he has yet embraced). A consistent theme of the perestroika debates is that while the need for drastic reform is evident to everyone acquainted with the performance of the Soviet economy, the political obstacles in the way of reform, primarily the interests of millions of government and Communist Party bureaucrats and managers whose jobs and perquisites depend on the current system of centralized state control, are so formidable as to make reform extremely difficult and perhaps impossible short of revolutionary upheaval.

This dilemma, in form if not extremity, is reminiscent of the situation in the United

States in the middle 1970s, when a small vanguard of economists, political scientists, and reform-minded politicians were convinced of the need for sweeping deregulation of America's transportation, communications, energy, financial services, and other regulated industries, but seemed to face insuperable opposition from government bureaucrats, private interest groups, and others with an interest in preserving the status quo. The American reformers succeeded, however, to a greater extent than they or anyone else imagined they might, and their successes have been matched in other democratic nations from Conservative Great Britain to Laborite New Zealand. Perhaps this experience can provide not only encouragement but a few practical lessons to Soviet reformers.

And American-style economic regulation, precisely because it is a middle ground between the government managed economy and the pure market economy, may offer lessons of its own to those who wish to move from the former toward the latter and are searching for practical first steps; indeed in the spring of 1990 there is increasing talk by Soviet reformers such as Deputy Prime Minister Leonid Abalkin that a "regulated market economy" is the goal of perestroika. In the sections to follow, I offer several lessons from the record and structure of American regulation and from the American deregulation movement of the 1970s and 1980s.

Lesson I

My first lesson is that you don't need to do everything at once, and don't need to do everything right, in order to obtain many of the benefits of a market economy.

Hand wringing over the political obstacles to economic reform is only half of the dominant, highly pessimistic theme of Soviet and Western discussions of perestroika. The other half, voiced by many Soviet reformers and American economist-advisers, is that even in the absence of powerful political opposition, economic reform will be immensely difficult simply because so many various things need to be accomplished. As one Western economist has put it, there is no "theory of transition" to tell us how to transform a massively state controlled economy into a market economy. And in the absence of such a theory, it is said that reform must advance on many fronts at once if the fruits of the market economy are to be realized. There must be reform of the Soviet currency and of foreign exchange policies, introduction of sensible fiscal and monetary policies, decontrol of prices and wages, decentralization of government administration, some degree of "destatization" and establishment of private ownership, introduction of efficient management incentives and overt price and product competition among independent enterprises, and much more—all at once. If any of these is neglected or mismanaged, there will be inflation, or corruption, or a failure of relative prices to reflect conditions of supply and demand, or a lack of entrepreneurial initiative, or inadequate foreign investment, or the continuing

overhang of billions of unused private rubles—any one of which could overwhelm the benefits of successful reforms and discredit the entire perestroika program.

This view of the situation is obviously terribly discouraging to would-be reformers, even more than the litany of political obstacles to perestroika. For it is simply not possible to get all of these things right in this imperfect world, much less get all of them right simultaneously and soon. Indeed if human beings were capable of orchestrating a reform program of such demanding complexity, the planned economy itself would not be nearly as problematic as it is and the need for reforming the Soviet one would be far less urgent. The all-or-nothing argument, which is a sort of litany of the preconditions of a perfectly competitive economy in equilibrium, also implies that there is no stopping point between communism and the thoroughly individualistic economy of Milton Friedman—the latter still being viewed with suspicion or contempt by many earnest Soviet reformers, never mind the traditionalists. I would be inclined to agree with them if I thought the all-or-nothing argument were true. If the market economy is really such a delicate orchid, can it really be worth the Herculean effort needed to produce it?

But the market economy is not a hothouse flower. This, in any event, is an important lesson I draw from the American experience with economic regulation, which is solid evidence that an economy can survive and prosper despite egregious and longstanding mistakes of "economic policy." The U.S. economy since the late 19th century has been a far cry from the pure market ideal; many of its most important and successful sectors have been heavily regulated in ways that have produced many of the distortions today's Soviet reformers are trying to correct. In the first seventy-five years of this century, Americans built the world's most efficient telecommunications system under a program of comprehensive and highly inefficient government controls which distorted prices, skewed investments, limited new entry and innovation, and dulled management incentives. Much the same could be said of the U.S. airline, railroad, trucking, and other transportation industries. When U.S. deregulators were trying to abolish price and entry controls in these industries in the 1970s, their opponents (primarily the regulated firms and their unions) responded by saying that America already had the best quality, lowest cost airline or telephone (or whatever) system on earth, so why tinker with it—and they had a point. Today some of America's most prosperous and productive industries are also among its most heavily regulated, pharmaceuticals and financial services being two conspicuous examples. American Nobel economists from Wassily Leontief to Milton Friedman have recently complained of the huge wastefulness of some of America's pollution control programs which apply across virtually all industrial and utility sectors.

None of this is to say that U.S. regulation has been irrelevant. I and, I daresay, most other students of the subject believe that economic regulation has generally served as a significant brake on America's economic performance, and that America would be a wealthier nation today (and also a more just nation, but that

is another matter) if its economy were less heavily regulated. At times—as during the period of President Carter's energy plan in the late 1970s—the social damage of U.S. regulation has been conspicuous as well as enormous.

Nor do I wish to minimize the pitfalls in the way of perestroika. Obviously, undoing the massive system of Soviet state controls is a massive task, and many an individual mistake could discredit the entire effort (especially monetary mismanagement, which seems to have been a critical failing of the Chinese reformers in the middle 1980s). But it is important to recognize that one can get a great many things wrong, including such things of vital interest to the professional economist as prices and the size and direction of business investment, and still enjoy many of the benefits of economic prosperity and progress.

This lesson should be an encouraging one to Soviet reformers, and not only as an antidote to the notion of planned, all-or-nothing economic reform. Democratic governments face innumerable popular (majoritarian) and special-interest-group pressures to pursue policies that are harmful to the performance of their economies. The Soviet government will face and succumb to many such pressures as it becomes more democratic, no matter how skillful Soviet reformers are in transforming traditional Marxism-Leninism to accommodate the emergence of private markets. The fact that democratic governments in America and elsewhere have found ways of responding to these pressures, while overseeing economies whose performance has been hugely superior to that of the state-managed economies, should give heart to those who fear that glasnost may prove to be the enemy of perestroika.

Lesson II

My second lesson is that the place to start building a market economy is private ownership of the means of production. This lesson may be as discouraging as my first lesson is encouraging, because it suggests that the place to start is in the area where reform is most difficult to square with Marxism-Leninism—the area many politically astute Soviet reformers would like to postpone until last.

The principal reason for the "success" of American-style economic regulation—"success" meaning that harmful policies have not fundamentally damaged the efficiency of our economy—is that even America's largest and most heavily regulated industries, such as telecommunications and electric power generation and distribution, have been privately owned and managed, and that the authority of the government regulators, while very great within its sphere, has also been tolerably defined and circumscribed.

Private ownership has meant that the profit motive—the power of self-interest operating in commercial affairs—has been continuously available to compensate for mistakes of government policy and make the best of inefficient pricing,

investment, and other policies. When the U.S. government set airline rates much too high in the 1960s and 1970s and aggressively restricted new entry into the industry, airline companies responded by competing in terms of enhanced service quality—something much more difficult than price for a government agency to monitor and control—thereby greatly reducing (though not of course eliminating) the consumer losses from the regulatory controls. When regulated prices were set either too high or too low in other regulated markets such as communications, energy, and financial services, entrepreneurs were able to enter the markets by developing substitute services outside the regulators' legal jurisdictions—services that could be offered at competitive, remunerative prices; that either attracted business from overpriced regulated services or shortened the queues for underpriced regulated services; and that typically garnered voting customers fast enough to avert the expansion of regulatory jurisdiction to embrace them.

Finally, in the area of "social regulations" such as environmental, workplace safety, and automobile and other product safety standards, the profit motive has minimized the costs of regulation in the same manner as it minimizes private production costs.

U.S. regulatory agencies such as the Environmental Protection Agency, the National Highway Traffic Safety Administration, and the Occupational Safety and Health Administration consistently overestimate the costs of their rules at the time they issue them, even though their political interest is to minimize these costs. This is because their cost estimates are necessarily based upon existing production methods and control technologies; but once a product or production standard is in place, regulated firms have strong incentives to minimize the costs of complying with the standard by altering their production techniques (in ways that are impossible to predict at the time the rule is issued). The standard policy advice of economists in this area of regulation—that agencies adopt broad "performance standards" rather than narrow "engineering standards"—is based on this simple insight, and aims to give regulated firms the widest possible leeway to minimize the costs of achieving environmental and safety goals.

Except in the field of "social regulation" just mentioned, the market response to government regulatory policies has not been much attended to by American students of regulation, who have been more interested in studying the political response to regulation (the "public choice" school) and in documenting the inescapable market inefficiencies of regulation.[1] And these questions—concerned with the dynamics of policy formulation and with distinguishing desirable from undesirable policies—are indeed the most interesting ones in the context of an advanced "mixed" economy. But I want to suggest that, where one is instead concerned with building an advanced economy from scratch and wants to know where to begin, one must be interested in a question antecedent to the design of desirable economic policies, and even antecedent to the design of political institutions that will tend to promote desirable economic policies—and

this is the design of social institutions that will minimize and counteract the effects of undesirable policies, which policies are bound to be issued in profusion regardless of a nation's political arrangements or the goodwill of its leadership.

The social institutions I have in mind are, first, the legal prerequisites of a private market economy and "capitalism." These are the base institutions of private property—procedures for assigning and recording ownership of land and goods, with apolitical court enforcement of property rights, contracts, and extracontractual liabilities—augmented by corporation (including bankruptcy) laws that facilitate extended contractual ownership, financing, management, and transfer of productive assets. That economic development and the reform of socialist economies must begin with these institutions is the view now associated with the research and writing of Peruvian reformer Hernando De Soto (1989). De Soto's emphasis, however, is on legalizing the underground or "informal" economy of socialized, underdeveloped nations in order to reduce the heavy transaction costs of doing business outside formal law, and he combines this with a regulatory reformer's prescriptions for simplifying administrative rules and subjecting them to public scrutiny and criticism. My point is the different although complementary one that privatization is more important than, and should precede, such policy reforms as rationalizing or abolishing price, output, and investment controls, state subsidies, and the like. It is more important because, in motivating the production of private wealth, it also motivates activities that minimize the social costs of inefficient government policies and political pressures for improving those policies.[2] Privatization, in the words of Lenin and Smith quoted at the beginning of this paper, links people's interests with the great ideal of wealth-enhancing economic policy, while suffering those interests the freedom and security to surmount the obstructions of wealth-destroying economic policies.

Beyond the legal rudiments of private markets and capital accumulation, there is another, equally important aspect of private property suggested by the American experience with government regulation. This is constitutional and derivative legal restraints on the powers of government regulators, without which U.S. common law and commercial law would pretty clearly have been overridden by regulatory controls to the extent of malting private property contingent on government discretion, which is to say a nullity. In the American context, constitutional constraints have taken two forms: (a) explicit limitations set out in the due process, equal protection, and just compensation clauses of the federal Bill of Rights (and similar provisions of state constitutions), and (b) the practical consequences of our constitutional structure, particularly the separation of powers within the national government (and within most state governments) and the federalist division of powers between the national and state governments.

The extent of the explicit constitutional guarantees against regulatory encroachments has been a subject of perennial controversy in American law.[3] It is uncontroversial, however, that the constitutional provisions in question at least prevent regulatory controls from effectively destroying the economic value

of underlying productive assets[4] or confiscating private property for public use without "just" compensation,[5] and that they oblige regulatory agencies to inquire formally into the economic effects of their rules and publicly justify their decisions. These are important protections, and their contemporary vitality is illustrated by the legal fallout from California's "Proposition 103." In 1988 the citizens of California voted by public referendum to reduce drastically the price of automobile liability insurance in the state; but the federal courts held, in response to legal challenges from the insurance companies, that the state could not reduce rates below a level that would yield the companies a "reasonable" return on their investments in providing the insurance. In this manner the U.S. Constitution transforms populist uprisings into lesser, more manageable mischief—desultory administrative hearings concerning the details of business expenditures, services, financing, and profits. The constitutional bulwarks are not as high or as strategically placed as many American deregulators and free market proponents would like them to be, but they do oblige public officials to provide a modicum of specific justification for their regulatory initiatives and encourage a spirit of compromise, all the while affording producers continuing "economic space" to go about their business.

The implicit property protections of the American constitutional structure—the separation of powers and federalism—are probably even more important to the issue of perestroika. In the American constitutional scheme, the Congress "makes" law and the executive agencies, including regulatory agencies, "execute" this law. Of course the execution of any general law involves innumerable questions of interpretation, and therefore the "making" of law at the margin. But the discretion of U.S. regulatory agencies is in fact limited to such questions of interpretation. When national regulation was in its infancy during the New Deal period, President Franklin D. Roosevelt and his advisers believed that the orders of regulatory agencies should be final and unappealable (like the current Soviet government they had a crisis on their hands and wanted quick action, and moreover they faced a judiciary that was unsympathetic to much of their program). But the courts held, in essence, that since the agencies were applying congressional law, and since the judiciary (not the executive branch) was the final arbiter of the meaning of this law, therefore the agencies' rules were subject to judicial review concerning their fidelity to the agencies' enabling statutes. The upshot was a large body of "administrative law" which, as pertinent here, requires the regulatory agencies' statutory interpretations, and their exercise of whatever discretion the statutes give them, to "be reasonable".

As in the case of the explicit constitutional protections, there is a tendency for American lawyers and regulatory economists to minimize the effectiveness of judicial review as a restraint on regulation. But in doing so they take for granted features of the American scheme that are most important in the Soviet context. American courts do routinely overturn federal and state rules at the behest of regulated firms, on grounds the agencies have exceeded their statutory mandates or have exercised discretion in ways they have failed to explain and

justify. Despite ingenious and partially successful efforts by Congress and the regulatory agencies to give the agencies broad de facto lawmaking discretion, the courts' continuing ability to "regulate the regulators" has been critical to preserving private autonomy and market resilience in the face of erroneous policies. Here are two illustrations:

1. In the 1970s, the U.S. Federal Communications Commission embarked on a lengthy effort to extend its controls to the computer industry, which was wreaking havoc with the FCC's controls of the telecommunications industry (as "communications" and "data processing" technologies converged, unregulated computer equipment was increasingly being substituted for regulated telecommunications transmission and office equipment). The effort foundered on the Commission's inability to define computer services in a manner that placed them clearly within its statutory jurisdiction and was technologically stable. The Commission abandoned its quest following a string of court reversals, and since then the increasing versatility of computer technology has proved to be a powerful force (one of several) eroding the FCC's practical ability to regulate telecommunications prices, investments, and service offerings. Partially as a result, the Commission has come to be fairly strongly committed to deregulation of major sectors of the industry.

If the FCC had had the final say about its legal jurisdiction, it not only would have outflanked the new technologies and thus preserved its practical jurisdiction, but no doubt would have proceeded, through expanded price and service controls, to retard substantially the market diffusion of those technologies—the telecommunications firms already subject to FCC controls, and familiar with its procedural rituals, would have seen to that. The result would have been not only direct damage to an important sector of the American economy, but the squelching of private markets that stimulated political pressure for removing existing, increasingly obsolete regulatory controls. And if (to carry the horror story one step further) the FCC had had the power to extend its controls willy-nilly to any aspect of the computer industry it wished to regulate, it might have imposed quite substantial damage on large portions of the American economy.

2. The several federal agencies charged with regulating U.S. commercial banks and other financial institutions have similarly lost a good deal of their practical ability to control financial markets due to recent market and technological innovations. In the 1970s the Federal Reserve Board would dearly liked to have regulated money market funds in the same manner as commercial banks—imposing on these new financial vehicles the same capital and insurance requirements and (especially) interest rate controls as applied to banks, in the absence of which the money market funds were attracting billions of dollars in deposits from banks. But such controls were clearly outside the FRB's jurisdiction, and Congress was unwilling to extend this jurisdiction. If it had, the immediate cost to U.S. consumers would have been fabulously large; more important, the rapid growth of the money market funds would have been nipped in the bud—

and it was this growth that promptly led the FRB (with the support of the commercial banks themselves) to abolish interest rate controls on bank deposits, which was one of the most beneficial deregulation actions in recent U.S. history. The FRB and other regulatory authorities have attempted to extend their jurisdictions to embrace many other newly emerging financial services during the past fifteen years, but most (not all) of these efforts have failed, and the FRB itself, like the FCC, has now pretty much acquiesced in the march of technology and become a mild proponent of financial market deregulation.

Innumerable further examples of the practical importance of jurisdictional limits could be offered, but the general sequence should be clear from the two just given. Government regulation of private markets is inherently unstable. Inefficient rules regarding pricing, business investment, product and service offerings, and market entry and allocation sow the seeds of their own destruction in private market economies, because they create incentives for firms to create unregulated products and services that are economic substitutes for the regulated products and services. And even efficient regulations, such as well-designed price controls in monopoly markets, become obsolete over time due to market and technical innovation. In either case, the regulatory agencies will be strongly inclined to resist the market developments, however beneficial, because they threaten both the economic interests of the firms they regulate (whom the agencies come to see as "clients") and the bureaucratic interests (for institutional maintenance and enhancement) of the agencies themselves. Jurisdictional limitations, enforced by and kept against these perverse political tendencies.

This implicit protection of private property is, of course, subject to the discretion of the U.S. Congress (and state legislatures), which is limited only by the explicit constitutional guarantees mentioned earlier. But here there is a further structural bulwark, erected with great care by the framers of the U.S. Constitution—the difficulty and costliness of legislative action itself. This aspect of the American constitutional scheme has probably grown in relative importance in the modern era of rapid technological change. A century ago, when the Interstate Commerce Commission was created to regulate the U.S. railroad industry, with what turned out to be serious negative consequences for the efficiency of the industry and the economic welfare of its customers, it took several decades before a well-developed trucking industry emerged to exploit the deficiencies of railroad transportation. This was plenty of time for the ICC and the railroads to engineer a legislative expansion of the Commission's jurisdiction to embrace trucking, which came in 1934. But today and for the foreseeable future, the pace of technological change and market development seems to be much faster—while the U.S. Congress remains the incorrigibly cumbersome, slow-moving institution its designers intended it to be. The modern regulatory agency is indeed an effort to avoid the deficiencies of direct legislative action in an era of rapid market change, and judicial review the price the Constitution exacts for the circumvention. While there are still many instances of legislative suppression of new markets, there

are a gratifying number of cases where markets have gotten themselves established too quickly for Congress to exert itself on behalf of the status quo.

The federalist nature of the American scheme of government has also been a powerful protector of private markets and restraint on harmful economic policy. In some areas—such as corporation law, where firms may choose to be incorporated and governed by the corporation law of any of the fifty states—American federalism amounts to outright national "policy competition," which has been shown to have pronounced beneficial tendencies (Romano, 1985). In many other areas, including taxation as well as regulation, the ability of firms to "vote with their feet" in making business location decisions provides some, albeit milder, pressure in the direction of beneficial policy. But an aspect of federalism particularly relevant to the Soviet situation is its tendency to generate concrete evidence on the effects of different policies, and thereby to encourage a spirit of pragmatism in policy debates (at the national as well as state level) that would otherwise be more abstract and ideological. When airline deregulation was being debated in Washington in the late 1970s, by far the most powerful evidence in favor of deregulation was that unregulated intrastate airline fares in California (as between Los Angeles and San Francisco) were dramatically lower than regulated fares in comparable interstate markets (as between Washington and Boston). In financial market regulation, where authority is divided between the national and state governments, many state policies permitting the introduction of new services or relaxing controls on old ones have generated important evidence (as well as voting constituencies) for broader national reforms.[6] And in the politically contentious field of state regulation of electric utility rates, evidence that certain "expense disallowances" in some states end up raising rates by raising the utilities' costs of capital has been a beneficial restraint on populist regulatory policies.

Many of the particulars of the U.S. experience with deregulation have little apparent bearing on the task facing Soviet reformers. (It appears, for example, that one of the principal causes of the deregulation of the airline, trucking, and other transportation industries was the decline in the unionized sector of the U.S. labor force.) What is highly relevant to the Soviet situation is that property rights, competitive private markets, and the structure of regulatory policymaking—jurisdictional limitations, judicial review, and federalism—have combined to provide continuous, imperfect, but highly important market tests of the efficacy of government policies, and at critical junctures have generated hard evidence and political support for modifying or eliminating harmful policies.

Conclusions

The burden of the preceding discussion is that the best form of "economic policy" for Soviet reformers to pursue is the establishment of the legal bases of a private market economy, protected by an appropriate set of self-denying ordinances and

structural encumbrances on the legislative and executive organs of government, especially at the national level. Privatization could begin, as other Western advice-givers have suggested, by transferring ownership of dwelling units and agricultural land from the state to the individuals who live in and farm them. Next steps would involve the legalization of stock companies and private ownership of factories and other productive assets (extending far beyond the small retail establishments permitted under the current "cooperatives" law), and the establishment of legal institutions to facilitate the use of land titles and other property as security for loans and other financial arrangements.

From the standpoint of economic efficiency it makes no difference who gets the property or on what terms, so long as the property is freely transferable; but of course it makes a tremendous difference from the standpoint of wealth distribution and therefore of the political repute of the perestroika effort. Many see the sale of dwellings, farm land, and factories to dwellers, farmers, and workers as a neat way of absorbing billions of excess rubles while privatizing a large share of the economy. A politically superior approach, however, might be simply to give the assets away. After all, the Soviet state is supposed to control the property on behalf of the Soviet people, not for its own account, so the people should not have to pay to become owners rather than squatters. And in the case of politically controversial privatization, such as of factories, giving the assets to those who are most strongly opposed to privatization, such as factory managers and Communist Party members, could greatly reduce the opposition. "Buying off" political opposition in this way has proved a successful privatization tactic in the United States and other Western nations.[7]

There seems to be little likelihood, however, that Soviet reformers will adopt the program suggested here. President Gorbachev, himself a lawyer, has spoken forcefully of the importance of establishing a "rule-of-law society," and persistently emphasizes the need for "radical" economic reform and new institutions that encourage individual initiative rather than constant permission-seeking. Yet property rights initiatives have so far been only a small and timid part of the general perestroika program. President Gorbachev pointedly describes the program of the more radical wing of the Congress of People's Deputies as amounting to "capitalism," which he distinguishes from his own program for a "democratic and humanistic socialism." And even the "capitalists" seem to have an extremely limited notion of private economic organization; consider the recent statement of one of the brightest and most radical, Nikolai Shmelyov:[8]

"...we have to take into account people's psychology, which is the legacy of the last sixty years. For them, a private enterprise hiring a lot of labor would mean exploitation and they might burn it down. Some of our economists think we should allow private firms to hire ten to twenty workers, but I personally don't know where to set the limit. A thousand people working for one person is clearly immoral."

And it must be said that much of what has been recommended here, such as common law and the observance of judicial independence, cannot be adopted in any formal program at all but depends on, indeed consists of, social habits of longstanding tradition.

Two aspects of the current Soviet situation seem especially adverse to my proposals. The first concerns the distributive effects of private markets at the time they are first instituted. It is commonly said that the Soviet people are highly prone to envy, resentment, and intolerance of social inequality however merited, and are therefore likely to be hostile to a private market economy, which generates and indeed depends upon inequality even as it betters the condition of the least well off. I do not know if the Soviet character is really as it is said to be, or if there is any way of telling. Certainly the Soviets have lived with, and taken great pride in; many social institutions—in education, science, sports, chess, and the performing arts—that are based on competition and produce large, systematic, merit justified inequalities. As a people whose governing institutions went directly from feudalism to communism, they have never directly experienced a liberal social order and the sorts of income inequalities it produces—transient, market-mediated, and, at least to some degree, justified by demonstrable individual merit and social benefits. The Soviet people have obviously showed great resourcefulness in making the best of things under communism, through black market activities and "entrepreneurship in consumption"; perhaps their reputed enviousness has really been, as Mr. Shmelyov hints, justified cynicism about their economic system and the irrationality of its results.

But even if one heavily discounts their reputation for enviousness, one must still be concerned about the Soviet people's reactions to the income inequalities bound to emerge in the early stages of any serious effort to institute private property and organized capitalism. No matter how cleverly designed or impartially administered, any privatization program of the scope required in the Soviet Union will be certain to allocate large benefits in ways that are arbitrary or, worse, based upon political connections.[9] More fundamentally, the establishment of markets, whether by law or private discovery, is inevitably accompanied by large initial speculative profits and "prospector's rents." [10] Of all forms of economic gain, these are the most difficult for the average citizen to understand and countenance, because their social benefits, while often substantial, are largely abstract and intangible. The current prosecution of financial innovator Michael Milken in the United States, and our heated controversies over "program trading" and "leveraged buyouts," are only the most recent examples of the continuing suspicion of (successful) speculators and prospectors even in the most advanced and individualistic of societies.

Let us assume, hopefully, that once Soviet citizens experience markets that are thoroughly competitive as well as private, the lion's share of economic inequality

will be understood to be as justified, on grounds of individual merit and social utility, as inequality in ballet or gymnastics. The fact remains that getting there will require a politically difficult passage through highly uncompetitive markets with accompanying large, unfamiliar, and arbitrary (or seemingly arbitrary) gains in private wealth—a passage more difficult than anything in Western experience, with its centuries of legal and economic evolution. However artfully the Soviet reformers are able to describe a private market economy as being "democratic and humanistic socialism" (presumably by harnessing to the market large social welfare and insurance programs), the early appearance of such forms of private wealth is bound to be taken as evidence of "capitalism" at its worst. This seems to me the greatest challenge facing a perestroika that aims to scrap rather than modify the current system of state economic control.

The second problem is the current drive by President Gorbachev and his political allies for stronger and more centralized executive power. President Gorbachev seems to have a genuine appreciation of democratic values and the social importance of the "rule of law," and his efforts to strengthen his new "executive presidency" may be motivated less by personal aggrandizement than by a sense of crisis and need to counter the power of the government and Communist Party bureaucracies. Nevertheless, unchecked state power is naturally and incorrigibly the enemy of the secure private markets and individual enterprise on which the success of Gorbachev's economic program ultimately depends. The arguments and examples of this paper support the wisdom of the structural "auxiliary precautions" adopted by the framers of the American Constitution when there were similar calls for greatly enhanced national power.

President Gorbachev and his advisers are said to be students and admirers of the New Deal period in U.S. history. One hopes they will discover that a large number of New Deal initiatives were economically misguided, including the quest for unreviewable regulatory power. The New Deal era does offer one lesson, however, that could be very useful in the current Soviet context, and this is the virtue of nonideological pragmatism—an openness to evidence and willingness to experiment and shift course. The current civil strife in the Soviet Union, if it does not tear the nation apart, is likely to lead to a more federalist, less monolithic structure of Soviet government, which in turn raises the prospect of a diversity of approaches to economic policy similar to that which has been so constructive in the United States. The Soviet reformers ought to seize the opportunity, permitting the various Soviet republics wide latitude to try their own versions of perestroika and privatization, and attending to the results in shaping national reform.

References

- Ackerman, B. A. (1977): "Private Property and the Constitution", Yale.
- Becker, G. S. (1989): "Democracy and Economic Growth", *The Wall Street Journal*, January 19, p. A-8.
- Cohen, S. F. and K. Vanden Heuvel (1989): "Voices of Glasnost", Norton.
- DeMuth, C. C. (1986): "[The Case Against Credit Card Interest Rate Regulation](#)", *Yale Journal on Regulation* 3, p. 201.
- De Soto, H. (1989): "The Other Path", Harper & Row.
- Dorn, J. A. and H.G. Manne (1987): "Economic Liberties and the Judiciary", George Mason.
- Epstein, R. A. (1985): "Takings: Property and the Power of Eminent Domain", Harvard.
- Goldwin, R. A. and W.A. Schambra (1982): "How Capitalistic Is the Constitution?" AEI.
- Romano, R. (1985): "Law as a Product Some Pieces of the Incorporation Puzzle", *Journal of Law, Economics & Organization* 1, p. 225.
- Siegan, B. H. (1980): "Economic Liberties and the Constitution", Chicago.
- Stiller, G. J. and C. Friedland (1962): "What Can Regulators Regulate? The Case of Electricity," *Journal of Law & Economics* 5, p. 1

Footnotes

[1] Although there is a literature skeptical of the effectiveness of economic regulation, a prominent example being Stigler/Friedland (1962).

[2] Western political economists are inclined to see private economic interests as leading to political pressures for rather than against socially harmful policies ("political rent seeking"), especially in the areas of government market allocation, entry controls and subsidies. So I should repeat my assertion that the political expression of private economic interests is on balance highly beneficial. The assertion is, admittedly, largely intuitive, but the intuition is a strong one and must be a fundamental premise of any advocate of "democratic capitalism"; for a bit of empirical evidence see Becker (1989). I also think the beneficial tendency will be particularly pronounced when one is beginning with an economy constrained by massively inefficient price, output and investment controls, typified by the Soviet gross output system of managing production, whose

distortions would almost certainly impose very large net costs on virtual-ly all privately owned firms, rather than benefiting some firms or industries at the expense of others.

[3] See Dorn/Manne (1987), Epstein (1985), Goldwin/Schambra (1982), Siegan (1980) and Ackerman (1977).

[4] *Smyth v. Ames*, 169 U.S. 466 (1898).

[5] *Nollan v. California Coastal Commission*, 483 U.S. 825 (1987).

[6] Research by the present author on the rapid growth of consumer credit from states that had relaxed or abolished usury laws was influential in averting the passage of national credit controls. (DeMuth, 1986).

[7] U.S. airline firms operating at high-density airports long opposed the federal government's efforts to privatize valuable "landing slots" at these airports by auctioning them to the airlines. But when the government proposed, in the middle 1980s, to permit the airlines who had been assigned the slots administratively to sell them to other airlines—in effect transferring the slots to the incumbent airlines without compensation—the airlines supported the initiative and privatization was accomplished.

[8] Cohen/Vanden Heuvel (1989).

[9] My own clever scheme for buying off political opposition to privatization by making the most powerful opponents the initial owners would, of course, produce exactly this result.

[10] By speculative profits I mean gains to individuals who, through foresight or chance, realize an appreciation in the value of their assets due to market changes they are not directly involved in. By prospector's rents I mean gains to individuals directly involved in discovering or inventing something that turns out to have economic value; their gains arise from the fact that they were among the first to discover it, and persist until competitive entry brings prices down to costs.