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Making Soviet markets work

MARK HARRISON, lecturer in economics at Warwick University, examines the options open to the USSR as it makes the transition to a more market oriented society

THE Soviet economy needs a reform of retail prices. This means that rigid controls on consumer prices must be relaxed. Relative prices must change to make subsidised goods like foodstuffs and fuels more expensive; the prices of profitable – or unduly taxed – lines of output could be expected to fall, but the prices of many basic goods will rise.

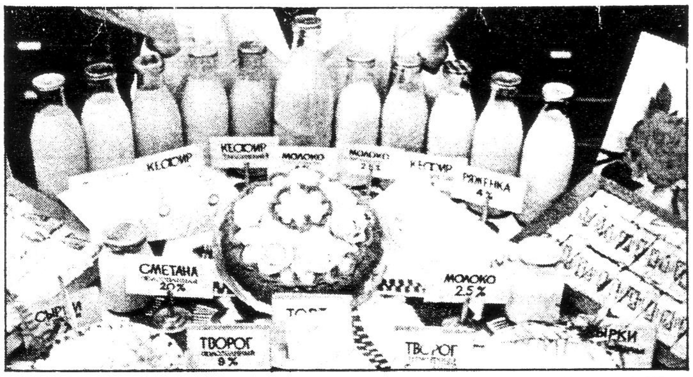
Why is this so essential? The Soviet economy is being shifted over to a more decentralised, more market oriented model. Firms are supposed to be increasingly self financed. But if relative prices stay fixed and out of line with costs, then demand for loss making commodities will grow while self financed firms will be reluctant to supply them. The market will not work properly; government officials will have to continue to tell firms what to produce, and in what quantity, since economically motivated decisions based on wrong prices will lead to the production of many basic goods being cut back. The momentum behind economic reform will be weakened.

Yet recent months have seen heavy pressure to postpone a price reform, and outspoken supporters of *perestroika* among professional economists, such as Aganbegyan, have shown readiness to draw back.

Price reform

Why the reluctance? One reason is that price reform means eliminating subsidies, and basic goods such as foodstuffs will see the biggest price rises. This would be regressive, hitting hardest at people on low incomes.

In principle, the Soviet government could compensate vulnerable households through higher wages and benefits for those on low incomes. As a result, relative prices could be altered while maintaining the existing distribution of real consumption.



Relative prices must change to make subsidised goods like foodstuffs more expensive

What stops this from being done immediately is the other reason – the danger of inflation. The pent up consumer demand for goods at existing, low official prices is high and rising. The Soviet public holds 370 billion roubles worth of cash and savings bank deposits, approximately equal to a whole year's purchases in state and cooperation shops. In proportion, today's 'overhang' of unspent purchasing power corresponds roughly to that accumulated during the years of World War II and post-war reconstruction, up to the 1947 monetary reform. Bogomolov reckons the unsatisfied consumer demand today at 20-40 per cent of household savings, and estimates the annual growth of inflationary pressure at 5-7 per cent.(1)

At present official prices are controlled, resulting in shortages, queues and rationing. This has many bad consequences. It stimulates corruption, blunts incentives and guarantees the unequal distribution of power between consumer supply agencies and Soviet workers, with the latter as consumers, always inferior, waiting, pleading, negotiating, forced to accept second best or none at all.

But price reform means that prices will be set increasingly by firms and farms, not by national authorities. If controls were relaxed, a sharp inflation would result. It would be impossible to assure either economic efficiency or social equity, and there would probably be a return to bureaucratic controls.

State v self finance

The most important source of continuing inflation pressure for many years has been the relationship between the Soviet firm and the provision of state finance.

- The Soviet firm is traditionally under pressure for quick physical results, and there results from this an indifference to efficient use of labour, materials and machinery. The state tolerates inefficient firms as the price of economic stability.
- The commitment to economic stability puts pressure on the state to finance much investment and meet most losses. (Losses not financed through the budget are met through banking credit.) Consequently, budget spending is more elastic upwards than either national output or tax revenues.
- The result is a rising budget deficit, only recently acknowledged. Bogomolov reckons the true 1988 USSR budget deficit at 100 billion roubles (much of this was 'covered' by savings bank deposits, but it all resulted in printing new money). This was 11 per cent of the Soviet national income – a proportion much higher than in the United States, although comparable with the position in Italy throughout the 80s and not uncommon in many developing economies. There, the immediate cause was usually the same – a tendency for government commitments to industry, defence and social welfare to rise faster than national income and tax revenues.
- In the Soviet Union this results both in excessive 'non-cash' financing of industry, and in excessive cash payments to workers in wages and bonuses, generating claims on consumer supplies which cannot be met.

In theory, self financing should cure the tendency of the budget and banking systems to extend excessive finance to industry. But self financing will not work without a price reform, and prices cannot first be reformed without confronting the huge inflationary overhang of accumulated cash in the hands of the population.

Options

How can the inflationary pressure be removed? Several options have been pursued in the years since 1985.

One possibility in the removal of inflationary pressure is to charge more for public services such as housing . . . but this is inevitably socially regressive

- One of the first options was 'acceleration' – trying to mobilise resources for additional output. But this was a very traditional, bureaucratically minded response to shortages, and has been shown manifestly not to work. Mobilising capacity and labour is always expensive, tending to push up unit costs and increasing the excess of firms' payments for wages, materials and machinery. As a result, even if consumer supplies improve, workers' consumer budgets expand still faster, worsening the state of shortage.
- There is also the possibility of charging more for public services such as housing, transport, education and health. But this is inevitably socially regressive, requiring further compensation of vulnerable low income households if social justice and acceptance are to be maintained.
- More recently, there has been emphasis on cutting back defence and investment spending on both Soviet produced and imported goods in order to release resources for consumer supply. This is a more hopeful course. Selyunin has argued that there is much scope for raising living standards out of non-consumption spending. Aganbegyan, Abalkin and Shmelev have all come out in favour of meeting additional consumer needs out of imports.

However, all hopeful possibilities are undermined while agricultural problems remain unresolved, leading to continued food shortages and rationing, and frustration of consumer purchases in official shops.

Monetary reform

Probably what the Soviet economy needs is a monetary reform. This means that on a given date Soviet citizens should be required to declare their holdings of cash and bank deposits and exchange old roubles for new ones at a rate substantially less than one. As a result, the overhang of excess money would be eliminated.

This is a drastic step. Moreover, it cannot be done gradually, or be preceded by consultation. If it were, then people would be forewarned of the diminishing future value of their cash holdings, and would seek to turn them immediately into real wealth. The entire money overhang would come crashing down on the retail market, clearing shelves and warehouses overnight and creating the likelihood of a runaway inflation.

It is also an unpleasant step. It amounts to partial confiscation. When it was last done, in 1947, the Soviet government could blame the existence of excess cash in the economy on the legacy of World War II. The big cash holders were portrayed as speculators who had capitalised on wartime food shortages to become rouble millionaires. There was counterfeit cash in circulation which also needed to be withdrawn. The main burden fell on cash holdings, while legitimate savings bank deposits were protected from confiscation. Any criticism could be instantly suppressed.

Today, much is different. The money overhang can be blamed in part on the Brezhnev legacy, but it has grown rapidly under Gorbachev, too. Undoubtedly many big money holdings have been acquired illegally, but with the general increase in living standards since 1947, the typical working family has legitimately acquired savings amounting to thousands of roubles. Another difference from 1947 is that today most people keep most of their money in savings; a monetary reform would shake trust in state banking as well as in the state currency.

Advantages

According to Shmelev, a monetary reform is being widely rumoured. Bogomolov describes such a move as 'unacceptable'. Nonetheless, there would be big advantages.

- Unlike a policy of price rises, monetary reform can be made progressive by converting larger money holdings into new roubles at a lower rate.
- Monetary reform can also have socially progressive effects, by cutting excess demand and prices in unofficial food markets. Low income families which do not have privileged access to state supplies at low prices will gain the most.
- By being sudden, monetary reform avoids any prolonged blunting of incentives to work for a higher income.
- If monetary reform must violate the principle of advance consultation within society, it is at least honest, admitting that the state today cannot honour its obligation to supply goods matching the citizens' claims on resources.

Properly, a monetary reform should be seen as part of a package. The rest of the package should include:

▷ ending food rationing,

▷ deregulating consumer prices,

▷ a partial shift from taxes on consumer purchases to progressive income taxes for budget revenues,

▷ cutting budget commitments to industry and maintaining progress towards self financing of firms.

▷ continuing the switch of national resources out of defence and investment so as to raise everyone's living standards during the reform process.

Past Soviet and Polish experiences show us that working class responses to sudden price increases imposed on basic goods can be bitter and violent. How would Soviet society respond to a drastic monetary reform? This would be a big test of the strength of informed social support for Gorbachev's regime. But there is no route for *perestroika* that does not involve big tests. ★

(1) *Pravda International*, Vol 3, No 2, 17-19