

CREDIBILITY IN SOVIET REFORMS

It must not be. There is no power in Venice
Can alter a decree established.
'Twill be recorded for a precedent,
And many an error by the same example
Will rush into the state. It cannot be.

William Shakespeare¹

INTRODUCTION

After six years of Mikhail Gorbachev, and despite all the talk about renewal and restructuring, the Soviet economy was worse off and the Soviet Union no longer existed as a political entity. As a program of economic restructuring and renewal, perestroika must be judged an absolute failure.² Glasnost to be sure produced a political and cultural awakening of sorts unknown during the seventy-four years of communist rule, but perestroika simply failed to deliver the economic goods.

As events in the former Soviet Union are continually unfolding it is rather difficult to get a handle on the full significance of current policy statements and initiatives and analyze them from an economic point of view. With the failure of the August 1991 coup, we have entered the post-perestroika era. We now know that reform communism has been rejected.³ But as for what will emerge, we will have to wait and see. What we do know, however, is that the perestroika period (1985-91), along with previous attempts at reform such as the New Economic Policy (1921-8), the Khrushchev's *sovnarkhoz* reforms (1957) and the Brezhnev-Kosygin reforms (1965), can now be safely treated as history.

Fortunately, sometimes the historical experience of one period

provides insights for understanding more contemporary situations. One such example is the Soviet experience with the New Economic Policy (NEP) in the 1920s and its parallels with perestroika. Many Sovietologists have pointed out the connection between the NEP and perestroika. Gorbachev himself argued that perestroika represented 'the most important and most radical reform our country has had since Lenin introduced his New Economic Policy in 1921.'⁴

Both the NEP and perestroika were broadly heralded as liberalization policies, and both came to an abrupt end less than a decade after they were initiated. The NEP and perestroika were simply not sustainable economic policies. The NEP, for example, was reversed in 1928 when Stalin began his 'revolution from above.' And, despite the collapse of the communist system, the consequences of the failure of perestroika are yet to be fully realized. Food shortages, declining production and social unrest are just some of the economic problems that the new leaders of the former Soviet republics will have to confront in the immediate future.

Understanding the reasons why both these liberalization attempts failed is important, not only for antiquarian interests, but also for what such an understanding can tell us about the general theory of social organization and public policy. An examination of the failing of the NEP and perestroika may offer invaluable insights for constructing a workable post-perestroika constitution of economic policy.

EXPLANATIONS OF THE FAILURE OF NEP

There is, as of yet, no professional consensus on what caused perestroika's unravelling, but for the NEP there does exist competing hypotheses. The *traditional* explanation is that the NEP failed because free markets cannot be relied on to provide the basis for industrial development.⁵ A backward country cannot be expected to develop without a massive and concerted industrialization program. The consequence of this line of reasoning is the 'Big Push' theory of economic development. Despite whatever excesses Stalin may have committed, it is argued that he was necessary to lift the Soviet Union from a backward peasant economy into a major industrial and military power. Alec Nove, one of the most respected Sovietologists, endorses this position when he argues that 'the survival of the regime, given the Bolsheviks' aims and their rapid industrialization program, required a harsh autocratic type of regime.'⁶

The traditional explanation has been challenged by the *reformists*.⁷

Reformists have argued that the NEP failed because of the political intrigue of Stalin. The NEP, they argue, would have developed the appropriate base for sustainable development and the advance toward a market socialist economy. In the reformist formulation, the personality of Stalin corrupts the revolution. Stalin was simply a 'bad' leader, who led the revolution astray from its humanitarian goals. The humane socialism of the 1920s, and specifically the alternative of Nikolai Bukharin, was sustainable, but co-opted by Stalin's ruthless quest for power. This line of reasoning, however, leads analysts away from focusing on the operation of the system and its institutional demands. It fails to appreciate the internal contradictions of interventionism that plagued the NEP with recurring economic crises throughout its history.

The *revisionist* interpretation attempts to avoid the failings of both the traditional and reformist explanations and offers a more telling narrative of the Soviet experience with the NEP.⁸ The focus in the revisionist interpretation is on the institutional structure and its impact on economic processes. The internal contradictions of the NEP, and the inability of the regime to establish a binding commitment to economic reform, are seen as the major reason for its failing as a liberalization policy.

The NEP failed neither because of the failure of unhampered markets to promote economic development, nor because of the political intrigue of Stalin, but because its institutional design was inconsistent with economic incentives and, therefore, could not mobilize the information that existed within the economic system and was necessary for the coordination of economic plans. In other words, the institutional structure of the NEP did not provide the appropriate environment for individuals to solve the coordination problem of economic development, and as such was doomed structurally to failure. The ensuing instability caused by a discretionary policy regime undermined attempts at liberalization. The same argument can be applied to perestroika.

INFORMATION AND INCENTIVES

Public policy must be constructed in a manner which recognizes the obstacles presented by information and incentives. Policy must first and foremost be incentive compatible with basic economic motivations. Policies that are based on notions of public spiritedness and humanitarian goals, but disregard economic motivations are most

likely to be doomed to failure. Moreover, even if public policies offer rewards to those who perform as expected, economic actors must possess the relevant information to act appropriately. If actors have the motivation to 'do the right thing,' they must nevertheless have access to information about what the right thing to do would be in their present context. The problem of obtaining relevant economic information is one that confronts even a benevolent ruler or regulator.⁹

The problem is that relevant economic information is dispersed throughout the economy in scattered bits and pieces and is not available to anyone in its totality.¹⁰ The price system, through the constellation of relative prices and the calculus of profit and loss, allows individuals to use this dispersed information in an economically effective manner. The social learning process of market competition reveals errors and motivates individuals to be alert to opportunities to correct their previous mistakes concerning the use and allocation of scarce resources. The daily changes in market conditions set in motion a process of mutual accommodation that translates the subjective assessment of trade-offs by some into effective knowledge for others. Within the context of the competitive market process individuals are able to discover and learn how to use information that is essential for the coordination of the production plans of some with the consumption demands of others.

Private property is a fundamental precondition in this social learning process because it affords market experimentation. Since private property, in effect, places the sphere of accountability for decision-making on the owner, this encourages risk-taking and innovation. The owner receives the rewards or suffers the losses of decisions in the market place. This context motivates individuals to be alert to, and learn of, opportunities for pure profit. The system of private property establishes a context in which various individuals are free to pursue all kinds of ideas. Accountability amounts to a legal responsibility not to infringe on the property rights of others, and the financial risk implied in the market experiment. With community property, however, the manager neither reaps the increase in the value of assets nor suffers the loss of asset depreciation. Decisions are accountable to committees and bureaus that decide 'social' goals.

The whole justification of substituting community property for private property is to somehow arrive at an *ex ante* criterion for eliminating mistaken decisions concerning resource use. But, such a substitution of community for private property stifles the experimen-

tation and learning processes that constitute the market economy. The trial and error experimentation by individuals within a market economy engenders a process of learning and discovery without which new methods and technologies for the use of scarce resources would lay hidden. Error, while costly to the individual market participant, is a fundamental driving force in the market system as a whole. The ability of the private property order to reveal errors and motivate learning is perhaps its most important function.

Policy should be structured in a manner which does not distort this social learning process. Unfortunately, the problem of constructing an optimal governmental policy that intervenes properly without distorting the flow of information is compounded by the passage of time. For one, relevant economic data is contextual and not abstract. Information gathered yesterday may be irrelevant for decisions today because of changing conditions. The price system overcomes this problem by alerting individuals to these changes through the adjustment of relative prices. Activity outside of the context of the market, however, does not have access to such a register of accommodating changes in intertemporal decisions. Even in cases where discretionary intervention might be desired to correct for perceived market failures, the problem remains as to how to acquire the requisite knowledge to intervene properly. Ignorant or haphazard intervention will simply lead to further destabilization and exacerbate the problem it sought originally to correct.

The dynamics of change associated with the passage of time also presents a timing problem for public policy, as Milton Friedman pointed out a long time ago. A long and variable lag exists between: (1) the need for action and the recognition of this need, (2) the recognition of a problem and the design and implementation of a policy response and (3) the implementation of the policy and the effect of the policy.¹¹ Because of these lags, Friedman argued that discretionary public policy will often be destabilizing. For this reason, he argued the case for *rules* rather than discretionary public policy.¹²

Finally, the passage of time introduces strategic problems for policy-makers. Policies that seemed appropriate at t_1 may not be deemed appropriate at t_2 . In fact, a basic presupposition of the argument for discretion is exactly that policies accepted for one period may prove to be inappropriate for another, and, therefore, policy-makers must possess the ability to shift policy as circumstances change. Such shifts in public policy (coupled with the impact that

these shifts have on the expectations of economic actors), however, may prove destabilizing to the overall economic environment.

THE ISSUE OF CREDIBILITY

Recognizing the temporal dimensionality of choice is one of the most fundamental issues in establishing viable economic policy.¹³ The analysis of both private and public choice must recognize the paradox that the passage of time presents to actors. Individual behavior, such as leaving credit cards at home when shopping or joining a drug rehabilitation center, are just some examples of attempts to solve the problem of 'multiple selves' as individuals construct themselves through time.¹⁴

Our concern here, however, is not with the individual choice problem, but with the public choice problem that follows from the strategic interaction between rulers and citizens. A fundamental problem faces public choosers when a policy that seemed optimal when introduced, appears less so as time passes.¹⁵ Without a binding commitment to the policy, the government will change policy to what now appears to be optimal. The problem is that economic actors who realize this will anticipate the policy change and act in a counter-productive manner from the perspective of the policy-maker.

Optimal intervention, by definition, requires that a large degree of discretionary control be entrusted to government decision-makers.¹⁶ The expectational problems of discretion, however, generate difficulties for government planning in general.¹⁷ Optimal intervention is simply not a possibility because of the problems of information and incentives discussed above. One reason discretionary control does not work is because current decisions by economic actors depend on expectations concerning future policy and those expectations are not invariant of the policies chosen. For example, if for whatever reason (either an increase in demand or reduction in supply) market conditions produced a windfall profit for the oil industry, the government could respond by proposing to tax away those profits with the argument that this will not affect the current supply of oil because it is the result of a past decision. But such a policy would lead oil companies to anticipate that similar expropriations will occur again in the future, and this expectation will impact on their investment decisions in a manner which will reduce the future supply of oil. Policy decisions and social rules create expectations and expectations guide actions.

WHY PERESTROIKA FAILED

These insights are directly applicable to the NEP and perestroika situation. The NEP period, for example, was one plagued by legal ambiguity toward private enterprise just as the position of the cooperatives was precarious at best under perestroika. During NEP

the population lived in uncertainty, fearful of breaking the law, afraid of what was to come. Paradoxically, those who were considered the victors (the workers) lived in poverty, although without fear, while those who knew they were the vanquished (the middle peasants, Nepmen, intellectuals) enjoyed material comfort, but lived in fear.¹⁸

The legal ambiguity toward private trade led Boris Pasternak to describe the NEP in *Doctor Zhivago* as 'the most ambiguous and hypocritical of all Soviet periods.'¹⁹

But while most scholars recognize the conflicting expectations between current market conditions and a possible future crack-down by the ruling regime, it is rarely systematically addressed within the usual analysis of the NEP or perestroika.²⁰ The establishment of a binding commitment which limits the regime's discretion is a fundamental prerequisite for successful market reforms. Without such a binding commitment reform efforts fail to produce the desired outcomes.

Perhaps the following scenario between the citizen and the ruler will illustrate the basic policy dilemma clearly. The ruling regime, which can either be sincere or insincere, announces a plan to introduce an economic liberalization policy. The citizen now must decide either to enter the market or stay out of the official market. A major problem confronting the citizen, however, is not knowing whether the regime in question is sincere or insincere. The citizen's only prior information concerning the regime is policy history, but the reform announcement was presumably intended to signal a break from the old way of doing things.²¹ If the citizen decides to enter the official market in expectation of continued liberalization, then the regime must decide either to continue the liberalization policy that was announced or renege on the announcement and tighten political control in the second round, for a host of ideological and short-term financial considerations, by cracking down on individual economic activity.

If the ruler is following a discretionary policy, then the citizen will foresee that the ruler may be likely to choose to crack down in the second period of this game, and therefore will choose to stay out. But

CREDIBILITY IN SOVIET REFORMS

if the ruler can convey a credible commitment, he would announce liberalization, and the citizen would choose to come into the official market. The ruler's payoff, independent of whether the regime is sincere or insincere, will be higher with commitment conveyance than it would be without it, but the insincere ruler would be better off once the announcement of liberalization elicited citizen market participation to pursue crack-down in the form of increased taxation, regulation or confiscation. The sincere reform regime, however, will not crack down and will continue to pursue liberalization policies.

In such situations, though, since the citizens are uninformed about the sincerity of the ruling regime, and given certain probabilities that are derived from their previous experience with the regime's efforts at reform, it may be rational for them to expect that the rulers will go back on their announcement to pursue economic liberalization. If this is the case, citizens will choose to stay out of the economic game, and, thus, defeat both the short-term and long-term goals of the ruler.²² The only way out of this policy dilemma for the ruler is to establish a binding and credible commitment to liberalization. Establishing just such a commitment, however, is the major problem of constitutional political economy.

The ruling regime's problem is even more difficult than solving the basic paradox in establishing constraints on their activities that do not deter their positive ability to govern. In order to get liberalization off the ground, the rulers have simultaneously to establish binding constraints on their behavior and signal a sincere commitment to reform to the citizenry. During war, for example, if his troops crossed over a large river to do battle with opposing forces, the commanding officer may order the bridge burned – thus pre-committing his troops to the battle ahead by eliminating the only possible escape. At the same time, however, opposing troops witnessing the smoke have received a signal that the other side will fight a hard battle. The reforming regime must do something similar to establish trust and bind themselves to the liberalization policy.

This simple illustration of the basic problem of policy design and the failure to solve the dilemma goes a long way toward providing an explanation of the failures of the NEP and perestroika. Specifically, an examination of the tax and license fees of the Nepmen (private traders) and the grain policy during the NEP and the policy toward individual labor activity and cooperatives during perestroika highlight the explanatory power of this simple game.²³

WHY PERESTROIKA FAILED
ILLUSTRATIONS OF THE PROBLEM

The policy game under the NEP

The introduction of the NEP in the early spring of 1921 represented a drastic reversal from the previous policies pursued by the Bolsheviks. During 'War Communism' the Bolshevik regime had pursued policies of extreme centralization that sought to eliminate completely market exchange and production and establish a centrally planned economy.²⁴ The 'War Communism' policies had to be reversed as they resulted in a drastic reduction in production and threatened the political alliance between the peasant and the proletariat. The NEP represented, in large part, a policy of economic liberalization that was intended to restore partial economic freedom to the peasants so as to appease the political unrest and spur the farm production that was necessary to feed the emerging industrial strata of society.

On 24 May 1921 a decree from Sovnarkom (Council of People's Commissars) permitted not only the sale of surplus food by peasants in farmer markets, but also trade by others of goods produced by small-scale private manufacturers. Whereas private trade during 'war communism' was basically outlawed – though it did continue in the form of black market bazaars – under the NEP sales could now be conducted from permanent facilities. Decrees concerning hired labor (not more than ten or twenty laborers), the leasing of factories, etc., followed throughout 1921 and 1922.

The property rights and legalized spheres of business activity that had been granted to Soviet citizens during the first two years of NEP were collected and set down in the Civil Code of the RSFSR, which went into effect on January 1, 1923. Although not a dramatic extension of the rights of private businessmen, the Civil Code . . . represented a clear reversal of the policies of War Communism.²⁵

This policy shift to partial liberalization was meant as an inducement to private economic initiative, and it worked to an extent. But the policy signal was not unambiguous. Nepmen were subject to many taxes and fees, including business and income taxes. The most substantial of these was the fee for the use of business facilities. In fact, this fee accounted for twice as much revenue from private traders as the business tax did in 1922. In January 1923, it was announced that the fee would be increased. At this time, applications to rent facilities for private business declined 20 per cent.²⁶

CREDIBILITY IN SOVIET REFORMS

The legal ambiguity of the Nepmen was highlighted in the laws against speculation and price controls. 1924, as a result of this, saw a marked decline in the economic activity of private traders. The government tried to reverse this downward trend by providing more favorable treatment to the Nepmen – for example, easy state credit. But this policy was again reversed in 1926/27. State credit to private business, for example, was cut by 25 per cent in 1926. The administrative tool that proved most devastating in the war against the Nepmen was taxation. There was a 50 per cent rate increase in the tax on profits of urban private traders from 1925/26 to 1926/27 (12.9 per cent to 18.8 per cent). In the Sokol'nicheski quarter of Moscow, for example, in 1929/30 private traders and manufacturers represented 1.7 per cent of the region's income tax payers, with 8.2 per cent of the total taxable income, but accounted for 55 per cent of the region's income tax receipts.²⁷ The tax burden, in combination with their political status as *lishentsy* (the deprived), assured that Nepmen were most vulnerable.²⁸ By 1928, as Aleksandr Solzhenitsyn points out, 'it was time to call to a reckoning those late stragglers after the bourgeoisie – the NEPmen. The usual practice was to impose on them ever-increasing and finally totally intolerable taxes. At a certain point they could no longer pay, they were immediately arrested for bankruptcy, and their property was confiscated.'²⁹

The cumulative effect of these policies was simply to discourage individuals from investing resources in the official market even though liberalization policies had been announced by the regime with the introduction of the NEP. Economic actors chose to withdraw from the economic game, despite the pleas from the Bolsheviks for them to 'enrich yourselves, accumulate, develop your farms.'³⁰

Price controls on grain provide another example. After the initial announcement of price liberalization, the government reversed course. In 1924, the People's Commissariat of Internal Trade attempted to fix a maximum price for grain. But over the years peasants had learned that grain was a good hedge against inflation. Tax pressures to enforce sales were enacted, but peasants did everything to pay the tax in anything other than grain. A private market developed where grain was sold above the maximum price – creating parallel markets, one state-regulated prices, another free prices.

In response, regional authorities attempted to issue orders declaring it obligatory to deliver 25 per cent of all flour milled in a region to the state-purchasing authority at the fixed price, but this merely led to

a cessation of milling operations. By December 1924 the state had collected less than half of its projected amount of grain (118 million pods out of 380 million). Moreover, the grain stocks of the state declined from 214 million pods on 1 January 1924 to 145 million pods on 1 January 1925. Price fixing policy by the state had been defeated.³¹

Foreign economic relations also provide another example of where despite the announcement of liberalization the inability of the regime to bind itself to a credible commitment undermined the reform effort. At the Genoa Conference (April–May 1922), for example, the Soviet delegation refused to conclude an agreement with Western powers on the question of Russia's debts.³² In addition, at the end of 1922 a proposal for relaxing the foreign trade monopoly was rejected. Prospects for the expansion of foreign economic relations were, therefore, reduced considerably. Without such ties, long-term economic development was unlikely. Foreign governments simply had no reason to trust the Bolsheviks in economic deals.

Exchange rate policy also hindered economic development and ran counter to the intentions of the NEP. The hard currency reforms in the beginning of the NEP – the chervonets reforms – were a major accomplishment, but they did not last even two years. The low levels of gold reserves, the unrealistic exchange rate and the small volume of Soviet exports, all undermined the monetary reform. Moreover, beginning in 1928, Gosbank refused to exchange Soviet money for foreign currency.³³

Finally, the general policy of grain procurement under the NEP illustrates the problem most clearly. The cornerstone of the NEP was the substitution of the tax in kind for the grain requisitioning of 'War Communism.' Peasants, though, with the war communism period still fresh in their memories had to be convinced that arbitrary requisitioning was not a policy option, i.e., the government had to make a credible commitment to maintain the NEP. However, as we have briefly seen the Bolsheviks did not commit to any such binding constraint. As a result, by the end of the 1920s (i.e., 1928) peasants no longer had an incentive to market grain surplus. From the peasants' point of view, the market was simply not a secure outlet.³⁴

Thus the NEP was abandoned in 1928 and Stalin ruled over the Soviet system until his death in 1953. The reversal from the quasi-liberalization of the NEP to the authoritarian measures of collectivization is one of the most drastic and fateful turns of events in the twentieth century. The abandonment of the NEP, though, did possess

both an economic and political logic. Not because market institutions cannot provide the basis for economic development, or because Stalin's personality was one that thrived on political authoritarianism. Rather, the internal contradictions of the NEP led to an ever-increasing reliance on the substitution of political rationales for economic rationales in setting economic policy. The shifting policies produced an expectational regime which worked against the goals of policy-makers. Since the Bolsheviks were not willing to construct a binding commitment to economic liberalization, the only way out of the policy impasse was complete authoritarianism. Stalinism was the unintended consequence of the failure of the discretionary regime of the 1920s to cope with the obstacles that information and incentives present to political economies.

The policy game under perestroika

The Gorbachev period (1985–91) offers a further illustration of the basic insight of the 'reason of rules.' For all our justified euphoria about the collapse of communism and the change in the landscape of global conflict, a fundamental uneasiness remains about the prospects for a peaceful transition to a market economy and constitutional democracy.

Just like the NEP, perestroika suffered from internal contradictions that precipitated its unravelling. Perestroika began as a policy of renewal and acceleration. It represented Gorbachev's public policy program to reverse the decline of the Soviet economy. Perestroika ended up, however, simply precipitating the crisis and collapse of the Soviet regime.

Cornerstones of perestroika included the law on individual economic activity (1986), the law on state enterprise (1987) and the law on cooperatives (1988).³⁵ Despite the rhetoric and promise of these laws, they did not go far enough to meet the objectives of economic reform. The laws contained contradictions and ambiguities that prevented their achieving desired results. Furthermore, they failed to convey any binding commitment on the part of the Gorbachev regime to real market reform. Rather, the decrees of perestroika left the clear impression that they were written on a word processor. From 1985 to 1991 Gorbachev introduced at least ten major policy packages for economic reform under the banner of perestroika; not a single one was implemented fully.

The law on state enterprise, for example, as discussed in Chapter 2

was supposed to introduce self-accounting, self-financing and self-management. But, unwilling to move too quickly with the reform of state enterprises, the government decided to stagger conformity to the law. Some enterprises would operate under the new guidelines as of 1 January 1988, others would do so the following year, January 1989. Such a staggered reform was similar (in both content and effect) to announcing that in order to improve traffic conditions the British system of driving on the left will be followed. But, in order not to disturb infrequent drivers (who may need time to adjust to the new rules of the road) it is decided that taxis and buses will drive on the left while ordinary drivers should continue to drive on the right until they have had time to prepare for the change to the new system.³⁶

In addition, given the commitment to full employment by the regime, there was no way to introduce self-financing in a manner consistent with a 'hard budget constraint.'³⁷ Enterprise managers and employees knew that despite whatever announcement was made concerning self-financing, that as long as the regime was committed to full employment, enterprises would possess a 'soft budget constraint' with all the corresponding inefficiencies.³⁸ Bankruptcy would not be tolerated and state subsidies would continue as before.

Not only did the law on state enterprises fail to aid the move to the market economy, it contributed to the economic problems of the already struggling official industrial sector. Managers in an effort to return the favor to workers for whom they owed their jobs, and since they did not face hard budget constraints, readily approved wage increases. Average wages rose by 8 per cent in 1988, and 13 per cent in 1989.³⁹ Thus, state enterprise costs increased and with that so did the demand for increased state subsidies from the enterprises. This, in turn, put an increased strain on the state budget, and, consequently, the monetary system as the printing press was employed to monetize the debt. The persistence of microeconomic inefficiency bred increased macroeconomic destabilization as economic agents responded rationally to the contradictory rule changes.

The law on private economic activity was passed in November of 1986 and became effective in May 1987. This law allowed individuals to engage in activities which previously had been deemed illegal. Despite several restrictions – such as the limit of time that state employees could devote to individual enterprise – the intent of the law was to encourage individual economic enterprise and market experimentation. Family members of state employees or individuals such as students, housewives and pensioners were allowed to work

full-time if they desired. In order to do so, though, individuals had to apply for a license granted by local authorities and pay either an annual income tax or a fee. The fee applied, in particular, to cases where it was difficult to monitor income, such as driving a taxi. The fee for a private taxi, in 1987, was 560 roubles, which meant that a worker who was 'moonlighting' as a taxi driver had to earn the equivalent of three months' wages before driving the taxi would cover its costs.⁴⁰ The perverse consequence of this policy in terms of the persistence of a 'black market' in taxis is described by William and Jane Taubman in their book *Moscow Spring*. The private market for taxi services had gone on for years. The law on individual enterprise, in this case, amounted to simply regulating and taxing an activity that had gone on 'unofficially' for years. As a consequence, very few if any of the Moscow *chastniki* (private taxis) they encountered were registered and, therefore, official. 'Registration,' they point out, 'required burdensome medical exams, payment of a fee, and of course heavy taxes . . . But most burdensome was the requirement that all individual labor activity be moonlighting; the workers must have primary jobs in the state sector.'⁴¹

An even more fundamental problem with the law on private economic activity was the existence of the campaign against unearned income.⁴² The campaign required individuals to have appropriate documentation explaining how they had made their money. A natural market response to this was the emergence of an illicit market in documentation. A less desirable consequence was a decline in economic well-being as the informal networks which historically filled the gaps caused by the inefficient official system were disturbed.⁴³ The attitude of the regime conveyed by the campaign simply reinforced the lack of trust citizens possessed concerning the commitment of the government to reform. Without a credible conveyance of commitment to market reform, farmers, workers and so on, did not have any incentive to invest in the above-ground market.

This is clearly seen in the development of cooperatives in the Soviet Union under Gorbachev.⁴⁴ The law on individual enterprise (adopted November 1986) provided the legal foundation for the cooperative movement since it permitted family members who live together to form businesses. Formal recognition of cooperatives came with the Law on Cooperation in the USSR, adopted 26 May 1988. Whereas the number of cooperatives was 8,000, employing 88,000 on 1 October 1987, by 1 July 1989 there were over 133,000, employing 2,900,000. The output of cooperatives amounted to an estimated 350

million roubles for 1987, 6 billion roubles in 1988 and was estimated to be 12.9 billion roubles by June of 1989. Despite this explosion in cooperatives, hostility, from the public and the government, toward the economic success of cooperatives threatened their long-term viability.⁴⁵ Since this hostility resulted in accusations that cooperatives' financial gains were made without any real effort – just exploiting the shortage situation – the threat of the campaign on unearned income was very real. Often, state shortages get blamed on the cooperatives. A state shortage of buns, and a state shortage of sausage, translates into a cooperative sandwich with its corresponding high price – at least that is how some described the situation.

The precarious position of cooperatives was compounded because they had to rely almost exclusively on the state sector for supplies even though they were not hooked up officially to the central supply network. Thus, cooperatives had to rely on illicit transactions, such as bribes and agreements with state enterprises, to obtain resources which simply increased their vulnerability to 'blackmail' both by officials and criminals. In fact, cooperatives were often assumed to be fronts for criminal activity.

In addition, the legal status of cooperatives and the tax policy to which they would be subject has changed often. Even before the end of 1988 a resolution was passed which sought to restrict the activities of cooperatives. In February 1989, republican authorities were given the authority over taxation policy toward cooperatives and were encouraged to set differential rates based on the type of cooperative, its pricing policy and so on. The 'speculative tendencies' of cooperatives were subject to criticism and authorities were encouraged to take steps to bring cooperative pricing more in line with state pricing. Cooperatives were subject to taxes ranging from 25 to 60 per cent of their income depending on their pricing policy. The August 1989 law on cooperative taxation, for example, established new regulations on cooperatives and tied taxation of cooperatives to the relationship between state and cooperative prices.

By constraining the freedom of cooperative and private market experimentation, the Gorbachev government prevented the market from serving one of its most vital functions – inducing an increase in the supply of goods in response to excess consumer demand. The demand side of the market bid up the price of goods in short supply, but the supply side was not free to respond. With the failure to increase supplies, it was inevitable that cooperative prices would rise. Consumers, therefore, could either wait in long queues at the state

store and attempt to purchase goods that became increasingly non-existent at the fixed state prices, or they could go to the cooperative market and purchase goods at high market prices until the shelves in these private stores were emptied. That is what the average consumer saw as the benefit of perestroika. Either way, expectations of a better future were dashed and the credibility of the reforms was irreversibly damaged.

The undesirable effect of the policies adopted under perestroika was not just limited to their incentive incompatibility with entrepreneurial activity. It went much deeper, and undermined the basic constitution of economic policy. The continual flux in the legal environment for the cooperatives conveyed a lack of commitment on the part of the regime to private sector experimentation. But, without such a commitment to protect the legal rights of the private sector, there was no way to induce the investment and hard work that were needed to develop the Soviet economy.⁴⁶ So, in addition to incentive incompatibility, there was the additional debilitating problem of adverse reputation that results from policy reversals and the failure to commit.

The inability to convey any kind of commitment to reform sealed perestroika's fate. The reforms simply could not get the economy going and the consumer crisis grew more acute.⁴⁷ The political instability of failed reforms, alongside deflated expectations on the part of the population, produced a highly troublesome situation for the Gorbachev regime.⁴⁸

In the fall of 1990, when Gorbachev backed out of his commitment to the radical 'Shatalin Plan' and moved to the right, he blew his credibility with his liberal allies. But perestroika had already cost him his credibility with communist conservatives. So the winter zig to the right did not gain Gorbachev much. As he tried to zag to the left in the spring of 1991, especially with the April compromise with Yeltsin, the right prepared for one last effort to regain control.

First, they sought to regain control through 'constitutional' means, and when that failed, they resorted to the August coup. Even though the coup failed, the failure certainly cannot be attributed to the success of perestroika. It was the failure of perestroika, in fact, that resulted in the coup attempt. As the regime kept on introducing liberalization policies only to go back on them, the official economy sank deeper into an abyss. The bureaucracy which was threatened by reform knew that more and more radical measures would be necessary to get out of the abyss. However, those measures would be clearly undesirable

WHY PERESTROIKA FAILED

from their point of view. So they sought to resist one more time. Fortunately, the effort was neither united nor skillful, and it fell apart in three days.

The unravelling of the Soviet Union as a political entity, however, is the unintended by-product of Gorbachev's policy of perestroika. The failure of the regime to convey the kind of commitment to economic liberalization that was necessary to reform the Soviet system proved to be perestroika's undoing.

CONCLUSION

One of the most basic insights of constitutional political economy is the necessity of rules to govern over economic activity. It is a research program which focuses our inquiry on the working properties of rules, and the processes of social interaction that take place within rules. By examining both the rules of social interaction and their impact on social processes, scholars can begin to develop ideas about workable constitutions of economic policy.

In developing a workable constitution of economic policy it must be recognized that the obstacles that incentives and information present to discretionary behavior are formidable. The Soviet experience shows that without effectively signalling and establishing a binding and credible commitment to broad liberalization, the behavior of the government simply destabilizes the situation.⁴⁹

The argument against government intervention in the free market process does not amount to asserting that government intervention must necessarily lead to totalitarianism. That was a misunderstanding of the argument on the critics' part. Rather, the argument suggests that interventionism produces unintended results which will be viewed as undesirable from the government's own point of view. Thus, interventionist policy constantly forces upon government officials the choice of either rejecting their previous policy or intervening even more in the attempt to correct the past failing. The argument is a stability argument. Intervention is just not stable as an economic and political system. The discretionary behavior of the government results in situations that undermine their own initiatives.

Whereas the instability of the 1920s in the Soviet Union led to Stalinism, the instability of the late 1980s has led to the dissolution of the Soviet Union. In either case, one a normative nightmare whereas the other offers normative hope, the experience illustrates the basic point: discretionary behavior on the part of the government fails to

CREDIBILITY IN SOVIET REFORMS

produce the stable environment that is necessary for economic prosperity. The insights that the Soviet experience offers should become basic material in developing a workable constitution of economic policy in the post-perestroika era.

- 39 See F. A. Hayek, *Law, Legislation and Liberty*, vol. 1, pp. 56-65 (see Note 6). The value of freedom of choice, Hayek argued, lies in the opportunities it provides for the discovery of unforeseen and unpredictable possibilities. As such, the loss suffered from restrictions on freedom of choice is not known. Therefore, freedom of choice must be held as a principle that must not be sacrificed for particular pragmatic concerns of a given time. If freedom of choice, instead, is treated as a matter of expediency, then it will lose out to coercive interference since we hardly know what concrete benefit freedom of choice will provide in any particular instance.
- 40 See the roundtable discussion between Andrei Sakharov, Yelena Bonner, Stephen Cohen, Ed Hewett and Victor Winston, 'Interpretations and perceptions of perestroika,' in Ed Hewett and Victor Winston (eds) *Milestones in Glasnost and Perestroika* (Washington, DC: Brookings Institution, 1991), p. 145.
- 41 See Yelena Bonner, 'Five years of perestroika: "bloodless revolution" or revolting development?,' *Glasnost* (July-September 1990): 4-8.
- 42 See E. Iasin, 'Destatization and privatization,' *Kommunist*, no. 5 (1991), translated in *Problems of Economics*, 34 (8) (December 1991): 5-22. estatization meant that the transition to a mixed economy would be accomplished through decentralized management without changing the ownership structure. State enterprises, for example, would be leased. The owner of fixed capital - the state - would remain the same, but the output of working capital would belong to the leasee. Privatization, on the other hand, represented destatization envisaged as the transfer of state property to other owners.

6 CREDIBILITY IN SOVIET REFORMS

- 1 William Shakespeare, *The Merchant of Venice* in *The Complete Works of William Shakespeare*, vol. 2 (New York: Bantam Books, 1988), Scene 4.1.
- 2 Andres Aslund, for example, even before the August coup concluded that 'Looking back at Soviet economic policy during the second half of the 1980s, it is difficult to avoid the impression that virtually every possible mistake has been made. Perestroika has proved to be an utter economic failure.' Aslund, *Gorbachev's Struggle for Economic Reform*, 2nd edn (Ithaca, NY: Cornell University Press, 1991), p. 225.
- 3 For interesting interpretative essays on the events in the former Soviet Union see Martin Malia, 'A new Russian revolution?,' *New York Review of Books* (18 July 1991), and 'The August revolution,' *New York Review of Books* (26 September 1991).
- 4 Mikhail Gorbachev, *Perestroika* (New York: Harper & Row, 1987), p. 33.
- 5 See Mark Harrison, 'Why did NEP fail?,' in K. Smith (ed.) *Soviet Industrialization and Soviet Maturity* (London: Routledge, 1986), p. 26, where he argues that the rejection of the NEP simply reflects 'the needs of a state committed to a rapid, large-scale industrialization to reduce the commitment of resources to agriculture and to enforce reduced living standards on both town and country.'
- 6 Alec Nove, 'The logic and cost of collectivization,' *Problems of Communism* (July-August 1976): 59.

- 7 See, for example, Stephen Cohen, *Bukharin and the Bolshevik Revolution* (New York: Oxford University Press, 1981(1973)), and Nikolai Shmelev and Vladimir Popov, *The Turning Point* (New York: Doubleday, 1989).
- 8 An attempt at developing the revisionist interpretation is made in Peter Boettke, *The Political Economy of Soviet Socialism: The Formative Years, 1918-1928* (Boston: Kluwer, 1990), pp. 34-8, 113-46.
- 9 See, for example, Israel Kirzner, 'The perils of regulation,' in *Discovery and the Capitalist Process* (Chicago: University of Chicago Press, 1985).
- 10 The classic statement of this problem is F. A. Hayek, 'The use of knowledge in society,' in *Individualism and Economic Order* (Chicago: University of Chicago, 1980(1948)). Also see Don Lavoie, *Rivalry and Central Planning* (New York: Cambridge University Press, 1985) and *National Economic Planning: What is Left?* (Cambridge: Ballinger Publishing, 1985), pp. 51-92.
- 11 See Milton Friedman, 'A monetary and fiscal framework for economic stability,' in *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953), p. 145.
- 12 The argument for rules rather than discretion can also be linked to the discussion of competitive market processes above. Since economic processes are in a constant state of flux, public policy that would also be in a discretionary state of flux would simply compound the instability and uncertainty of social arrangements. Fixed policy rules ground the constant flux of economic activity with some certainty. A variation of this argument with regard to the law is developed by Mario Rizzo, 'Law amid flux,' *Journal of Legal Studies*, 9 (2) (March 1980): 291-318.
- 13 See Geoffrey Brennan and James Buchanan, *The Theory of Public Finance* (New York: Cambridge University Press, 1985), pp. 82-96.
- 14 See Tyler Cowen, 'Self-constraint versus self-liberation,' *Ethics*, 101 (January 1991): 360-73, for a discussion of these issues associated with individual choice.
- 15 Clear presentations of this problem for public policy are presented in Herb Taylor, 'Time inconsistency: a potential problem for policymakers,' *Business Review (Federal Reserve Bank of Philadelphia)* (March-April 1985): 3-12, and 'Rules v. discretion,' *The Economist* (2 March, 1991): 71-2.
- 16 A classic defense of discretionary policy can be found in Abba Lerner, *The Economics of Control* (London: Macmillan, 1944).
- 17 See F. Kydland and E. Prescott, 'Rules rather than discretion: the inconsistency of optimal plans,' *Journal of Political Economy*, 85 (3) (1977): 473-91.
- 18 Mikhail Heller and Aleksandr Neckrich, *Utopia in Power* (New York: Summit Books, 1986), p. 217.
- 19 Boris Pasternak, *Doctor Zhivago* (New York: Signet Books, 1958), p. 387.
- 20 One exception to this is John Litwack, who has stressed that within the institutional arrangement of perestroika the leadership was unable to establish a credible commitment to liberalization policies. See Litwack, 'Discretionary behavior and Soviet economic reform,' *Soviet Studies*, 43 (2) (1991): 255-79.

- 21 Marshall Goldman *What Went Wrong With Perestroika* (New York: Norton, 1991), pp. 37-8, for example, emphasizes the point that all previous efforts at reform within the Soviet Union were viewed as a 'big lie' by the citizens of the former Soviet Union. The suppression of the kulaks in the 1920s and 1930s and Khrushchev's agricultural policies in the early 1960s had not been forgotten by the population and explain why individuals were reluctant to invest private income on economic ventures. Hardly a family in the former Soviet Union did not have a member that was directly affected by Stalin's terror, and this served as part of a historical memory which each citizen possessed concerning the nature of the CPSU. (See also Goldman, p. 116).
- 22 Henry Hazlitt discusses this particular problem of trust and strategic interaction in reforming a communist political and economic system in his novel, *Time Will Run Back* (Lanham, MD: University Press of America, 1986(1951)), pp. 126ff.
- 23 I recognize that several issues are bundled here. The reforms of the NEP and perestroika did not fail simply because of credibility problems. For example, many of the policies were simply incentive incompatible. And, it is also questionable to what extent the objective of liberalization was ever part of the agenda in either case. However, in attempting to tease out the different problems with Soviet reform history the credibility aspect provides fundamental insights into questions of policy design.
- 24 For an examination of the policies of 'war communism' see, Peter Boettke, *The Political Economy of Soviet Socialism*, pp. 63-111 (see Note 8). Also see Peter Boettke, 'The political economy of the plan,' *Journal des Économistes et des Études Humaines*, 1 (2) (1990): 91-138. For a discussion of the debate over the meaning of these events in Western historiography see Peter Boettke, 'The Soviet experiment with pure communism,' *Critical Review*, 2 (4) (1988): 149-82; Alec Nove, 'The Soviet experiment with pure communism: a comment,' and my rejoinder in *Critical Review*, 5 (1) (1991): 121-8.
- 25 Alan Ball, *Russia's Last Capitalists: The Nepmen, 1921-1929* (Berkeley, CA: University of California Press, 1987), p. 23. Also see N. Gubsky, 'Economic law in Soviet Russia,' *Economic Journal*, 37 (June 1927): 226-36, for a contemporary account of the Civil Code.
- 26 Ball, *Russia's Last Capitalists*, p. 30 (see Note 25).
- 27 Ball, *Russia's Last Capitalists*, p. 75 (see Note 25).
- 28 The Soviet constitution barred from voting or holding office:
1. people using hired labor to make profits;
 2. people living on 'unearned income,' which included income from private enterprises and property;
 3. private traders and middlemen.
- Lisbentsy* could not have careers in the military, or join cooperatives and trade unions, or publish newspapers or organize gatherings. In addition, they had to pay higher fees for utilities, rent, medical care, schools and all public services.
- 29 Aleksandr Solzhenitsyn, *The Gulag Archipelago*, vol. 1 (New York:

- Harper and Row, 1973), p. 52.
- 30 See Nikolai Bukharin, 'Concerning the new economic policy and our tasks' (1925) in *Selected Economic Writings on the State and the Transition to Socialism*, Richard Day (ed.) (New York: M. E. Sharpe, 1982), pp. 196-7. Ambiguity in the rules, Bukharin argued, would produce nothing but contradictory expectations, which would deter economic progress. Sizing up the situation, he stated, 'Consider the fact that the well-to-do upper stratum of the peasantry, along with the middle peasant, who is also striving to join the well-to-do, are both afraid at present to accumulate. A situation has been created in which the peasant is afraid to buy an iron roof and apprehensive that he will be declared a kulak; if he buys a machine, he makes certain that the communists are not watching. Advanced technology has become a conspiracy. . . . The result is that the middle peasant is afraid to improve his farm and lay himself open to forceful administrative pressure; and the poor peasant complains that we are preventing him from selling his labor power to the wealthy peasants, etc.' In response, Bukharin argued that 'In general and on the whole, we must say to the entire peasantry, to all its different strata: enrich yourselves, accumulate, develop your farms.' This statement, of course, later became a bludgeon in Stalin's hands to demonstrate Bukharin's rightist deviation.
- 31 E. H. Carr, *Socialism in One Country: 1924-1926*, vol. 1 (Baltimore: Penguin Books, 1958), pp. 208-9.
- 32 See E. H. Carr, *The Bolshevik Revolution, 1917-1923*, vol. 3 (New York: Norton, 1981(1953)), p. 377.
- 33 See G. I. Khamis, 'Why and when did NEP die,' *Leka*, no. 10 (1989), translated in *Problems of Economics*, 33 (4) (August 1990): 21, 24.
- 34 As Robert Conquest explains: 'When the market mechanism had failed to give satisfaction, requisition made up the shortfall, and the government then went back to the market. *But from the peasant point of view, the market was no longer a reasonably secure outlet, but one that might be superseded at any moment by requisition.* And in the further deterioration of market relations thus produced, the government remembered the success it had had with forced requisition, and did not reflect that it was the requisition of grain produced with the incentive of the market, and that in the new circumstances this was certain to shrink in quantity.' See Conquest, *The Harvest of Sorrow* (New York: Oxford University Press, 1986), p. 93.
- 35 See 'The law on individual enterprise,' *Pravda* (21 November 1986), translated in *The Current Digest of the Soviet Press*, 38 (46) (17 December 1986); 'The law on State enterprises,' *Pravda* (1 July 1987), translated in *The Current Digest of the Soviet Press*, 39 (30-1) (1987); 'The law on cooperatives,' in J. L. Black (ed.) *USSR Documents Annual* (Gulf Breeze, FL: Academic International Press, 1988), 7: pp. 122-51.
- 36 See Goldman, *What Went Wrong With Perestroika*, p. 140 (see Note 21).
- 37 On the concept of 'hard' and 'soft' budget constraints see Janos Kornai, 'The soft budget constraint,' *Kyklos*, 39 (1) (1986): 3-30; and *The Road to a Free Economy* (New York: Norton, 1990).
- 38 Litwack discusses the situation facing the Soviet manager in his paper

'Discretionary behavior and Soviet economic reform,' 257 (see Note 20). As he states

A Soviet manager . . . is often averse to expending resources for improving the performance of his or her firm. But this is not because of a well-defined progressive tax scheme that requires sharing future benefits with the government. The problem is that the tax scheme tomorrow is at the discretion of superiors in the hierarchy. They will determine conditions only after observing the performance of the firm today. In the absence of long-run commitment, these superiors naturally attempt to extract surpluses from those subordinate organizations that reveal themselves to be more productive. In addition, poorly performing enterprises are typically 'bailed out'. . . The expectation of discretionary extraction and bailouts creates an incentive problem at lower levels.

- 39 Goldman, *What Went Wrong With Perestroika*, pp. 141-2 (see Note 21).
 40 See Hewett, *Reforming the Soviet Economy* (Washington, DC: Brookings Institution, 1988), p. 340, fn. 60.
 41 William Taubman and Jane Taubman, *Moscow Spring* (New York: Summit, 1989), p. 46.
 42 See Misha Belkindas, 'Privatization of the Soviet economy under Gorbachev II,' *Berkeley-Duke Occasional Papers on the Second Economy of the USSR*, no. 14 (April 1989): 1-35.
 43 As Belkindas, 'Privatization of the Soviet economy,' points out opportunities for earned income originate because of the shortage economy. Illegal housing transactions, medical care, admission to an institution of higher education, etc., are just some examples of how illicit transactions can 'correct' for the failings of the official economy.
 44 See Belkindas, 'Privatizing the Soviet economy,' 37-97 for an overview of the development of private cooperatives in the Soviet Union. In addition, see Anthony Jones and William Moskoff, *Ko-ops: The Rebirth of Entrepreneurship in the Soviet Union* (Bloomington, IN: Indiana University Press, 1991). Also see David Prychitko, *Marxism and Worker Self-Management: The Essential Tension* (Westport, CT: Greenwood, 1991), for an examination of the theoretical and historical issues associated with the cooperative movement in general and its relationship to the main debates in comparative economic systems.
 45 See Anthony Jones and William Moskoff, 'New cooperatives in the USSR,' *Problems of Communism* (November-December 1989): 27-39. With regard to the hostility toward the emerging cooperatives they state that 'cooperative activity has . . . engendered a great deal of hostility from two groups: the consuming public, which it is supposed to serve, and the bureaucracy, which it threatens' (p. 32). Also see the discussion of the economic environment within which cooperatives had to operate and the array of official responses in terms of restrictions, interference and taxation which stifled the development of cooperatives in Jones and Moskoff, *Ko-ops*, pp. 34-77 (see Note 44). In addition, see Goldman, *What Went Wrong With Perestroika*, p. 113 (see Note 21). The

- halfhearted toleration of cooperative and private trade,' Goldman states, 'was guaranteed to sabotage the whole effort.'
- 46 The evolution of working capital markets, for example, depends crucially on the ability of the state to be bound by commitments that it will not confiscate assets. 'The shackling of arbitrary behavior of rulers and the development of impersonal rules' that successfully bind the state is a key component of institutional transformation. See Douglas North, *Institutions, Institutional Change and Economic Performance* (New York: Cambridge University Press, 1990), p. 129.
- 47 See Gertrude Schroeder, 'The Soviet economy on a treadmill of perestroika: Gorbachev's first five years,' in Harley D. Balzer (ed.) *Five Years That Shook the World* (Boulder, CO: Westview Press, 1991), pp. 31-48. Specifically on the consumer crisis, see James Noren, 'The economic crisis: another perspective,' and Gertrude Schroeder, 'Crisis' in the consumer sector: a comment,' in Ed Hewett and Victor Winston (ed.) *Milestones in Glasnost and Perestroika: The Economy* (Washington, DC: Brookings Institution, 1991), pp. 360-414.
- 48 'As Gorbachev moved back and forth from one comprehensive reform to another,' Marshall Goldman argues, 'he became more and more uncertain about subjecting the Soviet Union to the type of shock therapy such reforms would inevitably necessitate. He also concluded that unless reined in, the reform process would ultimately shrink his powers and those of the Soviet Union over central economic control, thus reducing the Soviet Union to an ineffective economic entity.' See Goldman, *What Went Wrong With Perestroika*, p. 222 (see Note 21). Gorbachev's economic zigging and zagging was not the only credibility issue at hand. The politics of discretionary power were also an issue of concern with liberal intellectuals. Individuals were not certain that the zigs permitted today would not be superseded by repressive zags tomorrow. 'Today,' Andrei Sakharov warned, 'it is Gorbachev, but tomorrow it could be somebody else. There are no guarantees that some Stalinist will not succeed him.' As quoted in Robert Kaiser, *Why Gorbachev Happened?* (New York: Simon & Schuster, 1991), p. 245.
- 49 Dani Rodrik has addressed the issue of commitment signalling with regard to policy reform in a game-theoretic framework. As he sums up his argument: 'At the outset of any reform, the public will typically be unable to fathom the true motivations of the government undertaking the reform. Since the distorting policies in question have been put in place by those in power to begin with, what reason is there to believe that the authorities now "see the light"? . . . Signalling via policy-overshooting can then help reduce the confusion. . . The more severe are the credibility problem and its consequences, the more likely it is that a sharp break with the past will be viewed as attractive.' Therefore, if the credibility gap is particularly important, as it is in the Soviet situation, then for the appropriate signal to be conveyed all notions of gradualism must be put aside. Policy overshooting can distinguish a sincere reform government from its insincere counterpart. Thus, policy overshooting will have the effect of rendering the policy reform more credible than it otherwise would be, and alleviate the problems associated with lack of credibility.

See Rodrik, 'Promises, promises: credible policy reform via signalling,' *Economic Journal*, 99 (September 1989).

7 CHARTING A NEW COURSE

- 1 Robert Kaiser, *Why Gorbachev Happened?* (New York: Simon & Schuster, 1991), p. 314.
- 2 See Paul Craig Roberts, "'Property owners' are rising from Russia's economic rubble," *Business Week* (13 May 1991): 16. As Roberts pointed out, though Gorbachev's reforms failed to produce results in the official sector, they unofficially succeeded by spurring the emergence of a *de facto* propertied class within whose hands the economic future of Russia rests.
- 3 See, for example, Jean Baechler, *The Origin of Capitalism* (Oxford: Blackwell, 1975), and Harold Berman, *Law and Revolution* (Cambridge: Harvard University Press, 1983). Also see Fernand Braudel, *Civilization and Capitalism*, 3 vols (New York: Harper & Row, 1982).
- 4 See Ludwig von Mises's discussion of the basis of human society in *Human Action: A Treatise on Economics*, 3rd rev. edn (Chicago: Henry Regnery, 1966), pp. 143-76. Also see Henry Hazlitt, *Foundations of Morality* (Los Angeles: Nash Publishing, 1972), and Murray Rothbard, *Man, Economy and State*, vol. 1 (Los Angeles: Nash Publishing, 1970), pp. 85-6.
- 5 The classic paper on this aspect of competition is Charles Tiebout, 'A pure theory of local expenditures,' *Journal of Political Economy* (October 1956), reprinted in Teler Cowen (ed.) *The Theory of Market Failure* (Fairfax, VA: George Mason University Press, 1988), pp. 177-92. Also see David Friedman, 'An economic theory of the size and shape of nations,' *Journal of Political Economy*, 85 (February 1977): 59-77.
- 6 See Bruno Leoni, *Freedom and the Law* (Los Angeles: Nash Publishing, 1972), p. 177.
- 7 Leoni makes the compelling argument that the problem of economic calculation under socialism is simply one case of the more general problem confronting complex human interaction; the discovery and use of knowledge that is dispersed throughout the society in order to accommodate the constantly changing conditions of human life. Leoni contrasts the evolution of judge-made common law which emerges out of an historical process with legislative law and argues that legislative law is vulnerable to the same problems that socialism confronts. See Leoni, *Freedom and the Law*, pp. 18-19, 90-1 (see Note 6). This is also a theme repeated forcefully in Hayek's writings. Also see the discussion in Bruce Benson, *The Enterprise of Law* (San Francisco: Pacific Research Institute for Public Policy, 1990), chaps 2-7, for a contrast between customary legal systems and authoritarian law. Chapters 4-7, in particular, discuss the public choice dimensions of authoritarian law under representative democracy. For a discussion of the contradictions of democracy see Murray Rothbard, *Power and Market* (Kansas City: Sheed Andrews and McMeel, 1977(1970)), pp. 189-99.
- 8 See Don Herzog, *Without Foundations* (Ithaca, NY: Cornell University

- Press, 1985) for a criticism of foundationalist justifications of political theory found in Hobbes, Locke and the utilitarians, and an argument for the adoption of the contextual justification for political theory found in David Hume and Adam Smith.
- 9 See John Locke, *Two Treatises on Government* (New York: Cambridge University Press, 1991(1690)) and Robert Nozick, *Anarchy, State and Utopia* (New York: Basic Books, 1974).
 - 10 See Thomas Hobbes, *Leviathan* (New York: Collier Books, 1962(1651)) and James Buchanan, *The Limits of Liberty* (Chicago: University of Chicago Press, 1975). Also see John Rawls, *A Theory of Justice* (Cambridge: Harvard University Press, 1971).
 - 11 See Israel Kirzner, *Competition and Entrepreneurship* (Chicago: University of Chicago Press, 1973) for a discussion of the limits of equilibrium as opposed to market process theory in exploring the properties of competitive markets.
 - 12 See James Buchanan, 'Ethical rules, expected values and large numbers,' *Ethics* (October 1965), reprinted in *Freedom in Constitutional Contract* (College Station: Texas A&M Press, 1977), pp. 151-68.
 - 13 Ironically, it is also the case that if in the Hobbesian state of anarchy individuals could come voluntarily to agree to form a social compact and establish a government, then there would be no need to form a government since voluntary action could solve the public goods problem. Either government represents the ultimate public good and therefore cannot emerge out of the voluntary actions of individuals within the Hobbesian jungle, or it can be established through agreement and therefore is not necessary. See Joseph Kalt, 'Public goods and the theory of government,' *Sato Journal*, 1 (Fall 1981), 568-84.
 - 14 See, for example, Hobbes's discussion of language and science in *Leviathan*, part 1, chaps 4-5. For a criticism of conventionalist views of social institutions, and money and language in particular, see Steve Horwitz, *Monetary Evolution, Free Banking and Economic Order* (Boulder, CO: Westview Press, 1992).
 - 15 While rule-making may be the product of rational design, the processes of rule selection are spontaneous. Thus, in principle rule constructivism is not as flawed an approach to social theory as the preceding paragraphs may suggest. The problem with the approach, however, is that it does not pay sufficient attention to the evolutionary feedback mechanism in rule selection. The approach I advocate to discuss the first principles of the liberal order seeks to explore both the reason of rules and the evolutionary processes by which rules are selected over time.
 - 16 See David Hume, *A Treatise on Human Nature* (Oxford: Oxford University Press, 1978(1740)), Book III, and Hume, *Essays Moral, Political and Literary* (Indianapolis: Liberty Classics, 1985), and F. A. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960), *Law, Legislation and Liberty*, 3 vols (Chicago: University of Chicago Press, 1973, 1976, 1979), and *The Fatal Conceit* (Chicago: University of Chicago Press, 1988).
 - 17 Hume argues that it cannot be denied that combinations of men were founded on a contract, but that this contract 'was not written on