

**The Russian Crisis,**  
**Perils and Prospects for Post-Soviet Transition**

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**Abstract**

Since 1992, the rhetoric of Russian economic reformers has been one of full-speed ahead to a free-market economy. The reality, however, has diverged significantly from this rhetoric at both a broad “rules of the game” level and specific “policy within rules” level. The resulting ambiguity of the economic environment and the lingering effects of the previous system which is supposed to be reformed has led to a continued deterioration of the Russian economy. This paper offers a modified defense of “shock therapy” as a path to a cure for Russia’s economic malaise, as opposed to the cure itself.

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## **The Russian Crisis: Perils and Prospects of Post- Soviet Transition**

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### **I. Introduction**

Russia is a country of unpaid taxes, unpaid wages, of poorly produced products and poor service, of credit expansion, but little long-term investment, of announced liberalization, but a growing black-market, of great opportunity, but intense capital-flight. In short, current Russia, as its Soviet predecessor, remains 'an enigma wrapped in a contradiction.'

Since 1991, the international community has provided \$90.5 billion of external assistance to aid the Russian transition. Thirty-five percent of that has been directed toward investment, twenty-five percent for export credit, seven percent for technical assistance, four percent for humanitarian and food aid, and twenty-nine percent for balance of payments and budget support. Sixty percent of this foreign aid has come from bilateral programs from G7 countries (Canada, France, Germany, Italy, Japan, United Kingdom and the United States) and the non-G7 countries (Denmark, Finland, Netherlands, Norway, Sweden and Switzerland). Assistance from the International Financial Institutions (the IMF, IBRD, IFC and EBRD), account for thirty-seven percent of \$90.5 billion committed to the Russian Federation.

This is not a trivial effort to aid Russia.<sup>1</sup> But there is also little to show for this effort in foreign aid. What has emerged in Russia over the past six years has not been a move toward the market, but a new variation on the older economic system known as the Soviet-type economy.<sup>2</sup> This is an economic system in which the main function of enterprises is not to compete in the open marketplace for goods and services, but is instead to protect oneself from the marketplace.<sup>3</sup> It is an economic system of innovative strategies at insulation from the rigors of market competition. The money sent to "prepare"

for marketization, in other words, was money spent on insulating strategies to protect enterprises from the promised marketization. Hindsight is 20/20, but the logic of the situation is straightforward. Confronted with announcements that are to take effect in a few months that would, if one were surprised, adversely affect some, will lead to fairly predictable responses by those who expect to be adversely affected by the proposed changes in the existing rules of the game to use whatever existing means are available to mitigate the adverse affects. Russia remains perhaps the prime exemplar of a "rent-seeking" economy in the modern world.<sup>4</sup> And, until that basic structural issue in the polity and the economy is addressed, efforts at transformation of the economic system in a direction which will enable the Russian people to live peaceful and prosperous lives will continue to fall short.

### **II. Background to the Current Situation**

Beginning in 1992, the rhetoric of the Russian government has been one of full speed ahead into a democratic capitalist society. The reality of Russian economic and political life, however, has fallen far short of that rhetoric. This is not unlike the foundational Gorbachev years, from which the Yeltsin government emerged. Gorbachev's reign from 1985-1991 set the stage for both the perils and prospects for post-Soviet transition.<sup>5</sup>

Yeltsin did not start from scratch. He started in an already existing political economy reality and that reality was one of negative value-added production, no alternative supply network other than the state, vast black markets both internal and external to the official state planning system, interlocking interest group relationships in politics and economics, a large level of distrust between private and public individuals, and little incentive for economic actors to behave in a transparently entrepreneurial manner. Entrepreneurship existed throughout the history of the Soviet Union, but it was limited to a range of arbitrage activities within the structure of the plan, or black market for

consumer goods. In other words, individuals recognized opportunities for mutual gain in the gaps caused by the failure of the official system, but there was no effective way for that “alertness to opportunities” to be transformed from arbitrage reshuffling to creative innovation. Gorbachev did not change that. In fact, Gorbachev’s failed reforms simply exacerbated the basic problem any reform government must confront – the quality of the signal concerning the credibility of the reforms proposed. The constant back and forth on reform measures that characterized Gorbachev’s years reinforced the distrust actors possessed in both the private and public sector.<sup>6</sup> Yeltsin’s reform strategy required that a credible commitment to reform be conveyed effectively to the populace, and yet that remains *the* major shortcoming of Russian transition policy since 1992.

Without a strong signal of binding reforms in the political, legal and economic structure, promises made are not trusted and thus the hoped for results do not materialize. If every promise made is understood to be nothing but another promise broken, then economic actors will not engage in the sort of long term investment and productive activity that is correlated with material progress.<sup>7</sup> Economic activity will focus on short term and easily transferable assets, and money made will find a more secure home outside Russia’s borders.

The enigma wrapped in a contradiction which represents current Russia is actually not one once we separate rhetoric from reality. The logic of the situation actually requires only a rudimentary knowledge of economics to both understand and propose viable solutions. When walking through Washington Square Park in Greenwich Village NYC, as I did daily through most of the 1990s, it was a common occurrence for me to be propositioned to purchase some illicit substance or another. If tonight it was announced that the ‘War on Drugs’ was over and all substances previously illegal could now be traded above ground, then my Washington Square Park “entrepreneur” would disappear. If I walked through the park in six months and he was still there, then it would seem obvious that something wasn’t so clear in that earlier legal announcement. That is Russia. Liberalization has been announced for close to a decade, yet

underground markets dominate economic life. The enforcement of contracts in this underground market creates opportunities for extralegal mechanisms, what we term “Mafia.”<sup>8</sup>

In addition to the broad topic of economic liberalization, there are also very specific reform measures where the rhetoric and the reality diverge so significantly that it is worth pointing out. One of the major problems with the Soviet system of economic management was that firm-level inefficiencies were converted into macroeconomic imbalances through the mechanism of “soft-budget” constraints. Subsidies to firms were paid for by budgetary imbalances, which in turn were financed through money creation. Since prices were administered during the Soviet era, this led to what was then referred to as the “rouble overhang” problem. Since the liberalization of many prices, the continuation of inflation finance has led to rising prices and a move out of the rouble and into harder currency (such as the US\$). The point to stress, however, is that inflation finance has continued throughout the Yeltsin years.<sup>9</sup> Despite claims to monetary and fiscal restraint, the reality of policy has been one of continued subsidies to inefficient state and quasi-state firms.<sup>10</sup>

Add to this monetary and fiscal policy environment, the regulation and tax policies which have been adopted and the sorry state of post-Soviet affairs is not surprising. Registration, regulation and tax policies have become major impediments to the development of new enterprises in an above ground market economy. The ambiguity and poor enforcement of property and contract by the official government has led to the rise of alternative enforcement mechanisms – some desirable, some not.<sup>11</sup> Compare the situation in Moscow and Warsaw for setting up a private shop. In a study reported in *Russian Economics Trends* (April 1997), it is reported that the average time for registration (in months) is 2.7 in Moscow, but only .7 in Warsaw. The average number of inspections in 1996 per private shop was 19 in Moscow and nine in Warsaw. In Moscow, 83% of those inspections resulted in fines, whereas the corresponding number in Warsaw was 46%. Finally, 39% of private shops in Moscow reported being contacted by the “mafia” within the last six months, while only 8% report similar

contacts in Warsaw.

The Russian people have had to endure a collapse of the economic system – as depicted by official economic statistics – that surpasses the decline experienced in the US during the ‘Great Depression’. During the last decade, the Russian economy has contracted by roughly half. There are problems with this official view which should be mentioned – namely, that (1) economic statistics overstate the health of the Soviet economy in 1989, (2) official statistics understate economic activity today because of the inability to accurately account for black market dealings, and (3) the difficulty of ‘reading’ production figures in a world of negative value-added firms. This last point is important because in such a world, curtailing production (which is measured as a decline in output) is actually a step toward increasing production and exchange efficiency. Unfortunately, in the former Soviet economy the welfare state was tied to state firms – in some case the entire range of health and human services – and if the firms are forced to shut down, then the social safety net (however ineffective it was) is also shut down. It is now estimated that 30 percent of the population is now living below the official poverty line.<sup>12</sup> Basic human indicators of well-being – life expectancy, infant mortality rates, etc. – are going in the opposite direction of what might be hoped. From the 1960s to the 1980s life expectancy had declined from 67 to 62 for men, since 1992 the decline has continued so that life expectancy for a Russian male is now in the mid to upper 50s.

Russia’s problems are enormous. Quick remedies are not possible as the problems are deep seated within the system and the history and culture of the people. It is not that Russians are alien to entrepreneurship or freedom of expression – the Soviet period saw both great entrepreneurial spirit in the black market, and a brave samizdat political culture. Moreover, Russian immigrants as a group do not have difficulty adjusting to the capitalist and democratic environments of Western Europe and the United State.<sup>13</sup> Nevertheless, the experience of ordinary Russian’s with markets and political decision-making is different from that experienced by those individuals who have been born in societies firmly rooted in Western values.<sup>14</sup> Cultural

constraints are felt at the level of the “legitimacy” accorded to the basic institutions of a market-order, civil society and political freedom. One of the important lessons of the failed experiments with development planning throughout the world is that, despite noble intentions, the most sustainable path to progress is an indigenous one. In other words, history and culture do indeed constrain our reformist zeal and, as such, must be taken into account in the analysis of any social transformation. While history and culture matter, they need not represent such a binding constraint that we must necessarily adopt a fatalistic conservatism. Cultural values can mutate, and history changes so as to put people along a different path than that previously traveled. We can use the background problem situation to highlight the issues which must be addressed and suggest institutional remedies.

### **III. Shock Therapy as a Path to a Cure, Not as a Cure in Itself**

The difficulties experienced in Russia have lead many to criticize the transformation strategy for (1) the uncritical adoption of a Western model, which is claimed to represent neither the only model of development, nor particularly applicable to Russia, and (2) for going too fast, where a more gradual strategy of transformation would have been more successful. The Chinese model is often then invoked as the counter-weight. Both of these arguments miss their target in my assessment for a variety of reasons. I will state those reasons in as bold a manner as I can to invite discussion. First, the conclusion to be drawn from world history of development patterns is that while there are many ways for people to live their lives, there are very few ways for those lives to lived prosperously as we currently define that term.<sup>15</sup> The Western model works for advanced material production, alternatives do not. This does not mean that the Western model can be imposed wherever and whenever we desire, but it does mean that absent the adoption of the *broad outline* of that model and an “economic miracle” is not to be expected. Second, the comparison with China misses the crucial point that while the Chinese have made very little *de jure* reforms of their political system, the *de*

*facto* changes have been enormous since 1985.<sup>16</sup> In fact, an interesting proposition to explore would be that while China has had less *de jure* reform, the *de facto* changes are far greater than in Russia, while in Russia there has been much *de jure* reform, but the *de facto* changes have been quite small. The follow up proposition could then be that what fundamentally matters for economic interaction is the *de facto* organizing principles of everyday life. Obviously, official rules are vital, but only to the extent that these statements on paper are interpreted to be binding rules in the everyday life of people.

Now is not the time to explore those propositions. I raise them only to suggest that the speed and timing debate could be argued to be misplaced. It is not really an issue of gradualism versus shock therapy, but an issue of no reform versus movement to a path of reform (however treacherous that path may be). In fact, the analogy to “shock therapy” should have suggested this formulation of the debate. Whatever the merits or demerits of the treatment with patients deemed mentally ill, shock therapy was not proposed as a cure in and of itself. The therapy was prescribed because in the judgement of the attending doctor the patient had so lost sight of reality that a drastic measure was required to get the patient back on a path toward recovery. Recovery, however, was a different matter altogether and could take quite a long time. To restate the analogy, the Soviet economy was structured in a manner so far from the reality of market competition that only an immediate step into the market context could initiate a process of social transformation. There are major problems with the shock therapy argument – namely, that history does not move in leaps, but in marginal adjustments from an existing context, and that no context (no matter how bizarre) exists outside the history and cultural of a people. Peter Murrell was right to challenge the model of the ‘Transition according to Cambridge’, but not because of speed related issues. The criticism, instead, should be grounded in a critique of the cultural naivete and the economic arrogance that history and deep seeded beliefs of a people can be safely ignored that characterizes so much of orthodox economic policy advice.<sup>17</sup>

But this criticism must be weighted against

arguments for the “shock”. It is my contention that a concern with history and custom need not be viewed in opposition to a demand for a shock. The demand for the shock, in this regard, follows from a set of arguments concerning the necessary simultaneity of monetary, fiscal, privatization, and domestic and foreign trade policy, and the question of pre-commitment in a world of rational distrust.<sup>18</sup> As we have seen with regard to monetary policy, without appropriate fiscal changes a restrictive monetary policy cannot be sustained. Unless privatization takes place and the subsidization of inefficient economic organizations stops, fiscal restraint cannot be established. And, unless there is freedom of entry, price liberalization will neither serve as an effective guide in resource allocation nor an inducement for the development of new entrants who will try to meet market demand. In addition, unless these policies are introduced against a backdrop of a legal-political structure which secures property and contract, the reform measures will possess incoherent incentives and signal a weak commitment to the reforms. The phrase “once bitten, twice shy” is particularly apt for economic actors in Russia.

Reform in real time must (1) start from the existing status quo, (2) unearth the *de facto* organizing principles of that status quo, (3) design a set of reforms which address the incentive and informational problems associated with that *de facto* system, and (4) send a clear high-quality signal that the proposed reforms are credible and commit the governance structure to the new system and in doing so close the gap for the *de jure* and *de facto* organizing system in the new regime. While these various steps must be made together, the consequences of making them should be expected only to be a movement onto the path of reform. Reforms in real time might require quick introduction, but results are a long time in coming. History does indeed only move in small steps, and not in giant leaps. Reform measures, however, should not be viewed as a historical leap, but part of history in the making.

The real difficulty with the post-Soviet era in Russia has been that most of the reform package has been inconsistent and provided incentives which are incompatible with the necessary restructuring. Even

worse, many of the proposed reforms have not even been implemented. Shock therapy has not failed as much as it has not been tried.<sup>19</sup> The signal sent to economic actors continues to be one which suggests that private and public predation of wealth creation is to be expected, and thus, economic actors do what is predictable – escape to the black market, hide assets or move them abroad, engage in only short-term investment. In short, markets are evident for all to see in a way they weren't during the Soviet period, but the view of markets is one of kiosks and bazaar style street trading, combined with crony-capitalist style small-scale production, and crony-socialism style large-scale production.

#### IV. Conclusion

It seems appropriate, given this events namesake, that I say something related to Henry George. George turned his attentions to political economy because of the contradictions evident in the persistence of poverty amid advancing wealth. He sought to explore the discipline and exam the logic of social relations which would explain the discrepancy and offer effective remedies to the social ill of poverty. George was concerned that political economy had been unable to unmask the source of inequity. Today I am not here to comment on George's own proposed reconstruction of political economy, but to draw some parallels between his task and the task confronting us today as it relates to the post-Soviet transformation. *Progress and Poverty* is not just an analytical tract, it is also a "transition" blue-print, and what he said about the state of political economy in 1879 still rings true today. That "after a century of cultivation," George wrote, "during which it has engrossed the attention of some of the most subtle and powerful intellects, [political economy] should be spurned by the statesman, scouted by the masses, and relegated in the opinion of many educated and thinking men to the rank of a pseudo-science in which nothing is fixed or can be fixed – must, it seems to me, be due not to any inability of the science when properly pursued, but to some false step in its premises, or overlooked factors in its estimates."<sup>20</sup>

The political economy of the transition that has

emerged in the 1990s has to a large extent focused on the wrong questions, approached the subject 'with some false step in its premises, or overlooked factors in its estimates'. This has mainly been manifested in the failure to account for questions of history, culture, legitimacy, etc. Russia's problems are not of a "technical nature". It is not a question of figuring out correct accounting practices, or voting procedures -- no matter how important these issues are for Russia's future. In developing a political economy of transition, we should, following George, "beg no question, shrink from no conclusion, but to follow truth wherever it may lead."

I believe that such a pursuit will lead us back to certain concerns which occupied the classical political economists. If Adam Smith were to go to Moscow, then I imagine he would highlight fiscal restraint, monetary stability, freedom of pricing and contract, and free and open international trade. But Smith would also counsel that "history matters", that the pursuit of self-interest can only be the source of social betterment within the confines of very specific institutional configuration, and that while the promise of progress is universal it will not be realized by all for a variety of human foibles and mishaps. Russia does not have an "economic" problem, it has a political, legal, cultural problem and that results in an extremely difficult political economy problem that must be solved if Russia is to overcome its problem with poverty through economic progress.

Smithian political economy sought to discover that set of institutional constraints that would enable men to peacefully coexist and prosper. Smith did not seek to create the best of all possible worlds, but instead to find a set of robust institutions of governance. F. A. Hayek sums up the research program as follows:

[T]he main point about which there can be little doubt is that [Adam] Smith's chief concern was not so much with what man might occasionally achieve when he was at his best but that he should have as little opportunity as possible to do harm when he was at his worst. It would scarcely be too much to claim that the main merit of the individualism which he and his contemporaries advocated is that it is a system under which bad men can do least harm. It is a social system which does not depend for its functioning on our finding good men for running it, or on all men becoming better than they now are,

but which makes use of men in all their given variety and complexity, sometimes good and sometimes bad, sometimes intelligent and more often stupid (Hayek 1948, 11-12).

This is both a positive and normative enterprise. It is a positive enterprise in the sense that we can examine alternative governance structures and how they impact upon economic performance by structuring incentives and determining the flow and quality of information that economic actors can utilize in orienting their behavior. It is a normative exercise in the sense that on the basis of the positive knowledge gained in the comparative analysis of governance structures, we can strive to introduce a *robust* set of political, legal and economic institutions.<sup>21</sup> The further development of the Russian economy requires that both these positive and normative exercises are pursued. That development will rest with the ability to establish institutions of governance which reduce political uncertainty by restricting the opportunities for public and private predation, and enhance the willingness of individual actors to “bet on their ideas” in the marketplace for goods and services. Unless this step is taken, the Russia people will not confront Henry George’s puzzle – how could there be poverty amidst progress? – because without material progress in the first place there will be no way to even make a step in the direction of addressing the problem of poverty that the Russians have had to endure during the Soviet and post-Soviet eras.

## ENDNOTES

1. Between 1948 and 1951, the US provided \$13.3 billion to European countries for post-war reconstruction, about \$90 billion in today’s dollar.
2. On the origins of the Soviet system see Boettke (1990). On the nature of the Soviet system in practice see Boettke (1993, 57-72).
3. See Gaddy and Ickes, (1998).
4. See Anderson and Boettke (October 1997). Also see Krugman (September 10, 1998) where he argues that post-Soviet Russia is run by a ‘looting’ band of oligarchs (or what Mancur Olson modeled as roving bandits). Because of the lack of security in the right to the flow of rents, these oligarchs have a very short-term time horizon. Krugman argues that the root of Russia’s current crisis lies in the inability to collect taxes from these ruling oligarchs who control Russia’s natural resources such as oil, gas, diamonds and gold, and the current crop of politicians. And, thus, while the problem is not so much that the Russian government is spending too much, the revenue short-fall has generated a fiscal imbalance which manifests itself in rising pessimism about the Russian government’s solvency. I do not deny Krugman’s account, but I would stress the continued subsidization of inefficient economic organizations which exacerbates the budget imbalance rather than the inability to collect taxes as the crucial problem.
5. For an economic and political history of the Gorbachev years see Boettke (1993).
6. Marshall Goldman (1991, 37 and 110) makes a similar point first about Khrushchev’s and then Gorbachev’s reform proposals. The proposed policies were treated as a “big lie” under Khrushchev and “indecision” and “inconsistency” associated with Gorbachev resulted in discrediting the reform efforts in both instances of attempted, but ultimately failed social transformation.
7. On the credibility and commitment issue as it relates to Soviet and Post-Soviet economic history see Boettke (1993, 88-105), Boettke (1995) and Boettke, (1998).
8. It is important to stress that the “mafia” in Russia is a direct outgrowth of the government system and is intertwined within the power structure. See Anderson (1995).
9. In January 1992 the Rb/US\$ exchange rate was 198, by May 1995 the exchange rate was 5054. This was during a

period of time when Russia was supposedly following “monetarism”. Political leaders, such as Viktor Chernomyrdin, repeatedly made statements that the monetarist program had failed, or that the era of market romanticism must end. After the pro-inflation central banker Viktor Gerashchenko was replaced with Sergei Dubinin in 1994 a “monetarist” program of restrictive-monetary policy was followed. But the necessary changes in the state budget and banking system were not made. Gerashchenko is now back in charge of monetary policy. In the aftermath of the recent currency crisis in Russia, the Institute for the Economy in Transition (Moscow) forecasts that the inflation rate for 1998 under four alternative scenarios will range from a low of 223% to a high of 297% (see the September 1998 economic report at <http://koi.www.online.ru/sp/iet/trends/sep98eng/3.html>).

10. For all the strides toward privatization one must keep in mind that the Russian state owns more than 10 percent of roughly a third of all privatized corporations and more than 20 percent of a quarter of privatized. Of the top 50 corporations, the state retains over a third of interest in them. Moreover, there are still several thousand firms that were never privatized in the coal, precious metals, health and communications industries. See Blasi, Kroumova, and Kruse (1997). Writing from a slightly earlier vantage point, Goldman (1996, 271) points out that “the most important indicator that privatization has had only a superficial effect is that thus far there has been relatively little product or managerial restructuring. As of 1995, only about 10 percent of newly privatized enterprises have had a change in management and that was initiated by a hostile vote of the stockholders.”

11. The intimate connection between monetary and fiscal policies and the more general level rules of the game changes that are required for effective change is recognized by Marshall Goldman (1996, 144) when he states that “Under the best of circumstances the reform would still have required decades to undo all the damage inherited from the decades of central planning. Nonetheless, Yeltsin and Gaidar and their associates and Western advisers can and should be faulted for concentrating so much on monetary, fiscal and price reforms and not enough on new investment and institution and infrastructure building. Had they done the latter, there would still have been difficulties, but there might also have been a few more success stories.” On the general relationship between private property and economic prosperity see Bethell (1998).

12. 44.4 million as estimated in September 1998. See Hiatt (October 26, 1998). Also see the Associated Press report (November 18, 1998).

13. Immigrant studies are, of course, problematic because of the systematic bias that those who chose to immigrate are more risk taking than their contemporaries at home.

Nevertheless, if the *people* have a problem, then even the risk takers should do relatively worse than other immigrant populations who do not have the problems of cultural resistance to capitalism and democracy. I have not found evidence in the literature that would suggest that Russians are disproportionately disadvantaged at adjusting to the new environments of capitalism and democracy.

14. On this point see Buchanan (1997a), (1997b) and (1997c).

15. See both Landes (1998). Also see Diamond (1997), and Sowell (1998).

16. On the development of “market-preserving Federalism” in China see Montinola, Qian, and Weingast (1995).

17. Murrell (1995). Also see Boettke (1994).

18. See Boettke (1993, 106-131).

19. See Sachs (1998).

20. See George (1879).

21. Robustness, rather than ideal efficiency, can become the welfare standard. How robust are institutions in the wake of opportunistic behavior, on the one hand, and sheer ignorance, on the other? Comparing states of affairs when people are both omniscient and benevolent does not provide us with much insight into real-world political economy. See Mises (1966, 692), where he states that socialism becomes an inescapable inference “as soon as people began to ascribe to the *state* not only moral but also intellectual perfection. The liberal philosophers had described their imaginary state as an unselfish entity, exclusively committed to the best possible improvement of its subjects’ welfare. They had discovered that in the frame of a market society the citizens’ selfishness must bring about the same results that this unselfish state would seek to realize; it was precisely this fact that justified the preservation of the market economy in their eyes. But things became different as soon as people began to ascribe to the *state* not only the best of intentions but also omniscience. Then one could not help concluding that the infallible state was in a position to succeed in the conduct of production activities better than erring individuals. It would avoid all those errors that often frustrate the actions of entrepreneurs and capitalists. There would be no longer malinvestment or squandering of scarce factors of production; wealth would multiply. The ‘anarchy’ of production appears wasteful when contrasted with the planning of the *omniscient* state. The socialist mode of production then appears to be the only reasonable system, and the market economy seems the incarnation of unreason.” Mises left the assumption of

benevolence alone, but challenged the assumption of omniscience. He focused particularly on the fact that even given perfect technological knowledge, economic planners without the assistance of the practices and institutions of the market process would be unable to determine the relevant economic knowledge required to assess the alternative use of scarce factors of production. Public choice scholars, on the other hand, have generally taken the different tact of challenging the assumption of benevolence. A robust political economy should work from a starting point which accepts neither benevolence nor omniscience. I believe there is a good case in human affairs in striving to build institutions from pessimistic assumptions about motivation and knowledge and thus guards against worst case situations.

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