The Future of Russian Capitalism
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THE FUTURE OF RUSSIAN CAPITALISM

For years Western observers had assumed that as the transition from socialism to capitalism proceeded in the Soviet Union there would appear a gradual shift away from strict state control of production toward some form of market socialism. Some property and productive assets would move from collective to individual ownership, but not all that much. Market forces of supply and demand would take over some of the responsibilities of allocating resources, but the state would retain a dominant role in protecting the population from the excesses of capitalism. Russia would more or less fit itself into the Swedish model. The dynamic of capitalism would be safely subordinated to the imperatives of a welfare state. How could it be otherwise? After seven decades of collectivism, the people of Russia and the former Soviet republics must surely have lost all memory of commercial competitiveness.

In fact quite the opposite conclusion might be drawn. During the 70 years of the communist experiment the competitive impulse of Soviet man has not been extinguished at all, but rather has been channeled into the awkward mazes and blind alleys that ultimately led to abandonment of the Marxist-Leninist idea. Now freed of these constraints, it is easy to imagine these competitive impulses racing ahead of our Western form of corporate capitalism, which has grown flabby and slow. It is possible to imagine a future of Russian capitalism that asserts itself early in the 21st century as the envy of the world.

In this difficult time of Russia's conversion from one system of political economy to another, it might seem sheer fantasy to present such a notion. The objective, as an alternative to the Swedish model, is worth considering, however. The Russian people are now engaged in nothing less than designing the basic architecture of a brand new country. Why not consider all possibilities? Why not design the Russian system of capitalism to be the best?

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II

Before exploring the future of Russian capitalism, we should be clear about the past. Karl Marx was extremely close to the truth when he completed his examination of capitalism in the midst of the nineteenth century: capitalism could not succeed because capitalists would sow the seeds of their own destruction. That is, if capitalism requires relentless competition, yet capitalists are doing everything they can do to destroy competition, we have a system that is inherently unsustainable—as with animals who devour their young.

Here is the problem: if successful capitalists can control the apparatus of government in order to prevent a new growth of capitalists, the system will inevitably destruct. If a system can be devised that prevents successful capitalists from controlling the apparatus of government for their narrow interests, though, there is at least a chance of renewal and a prospect of success.

The system Marx did not contemplate took another half century to reveal itself. It came in the form of a secret political ballot, the key to democratic choice, the key to unlocking the wisdom of the masses. If the people collectively know which course of action is the wisest, as I believe they do, they must be provided a safe channel to express that opinion.

In creating a system of Russian capitalism there is no more important ingredient than this—a democratic mechanism that protects the collective wisdom of the electorate. Mikhail Gorbachev called it glasnost. In that he was correct: the democratic structure of the political economy is far more important than the economic structure. The economic structure must change continually to keep pace with changing times in a competitive world economy; an optimum democratic structure provides the foundation for such change, enabling the people to exert their wisdom in guiding the direction and contour of economic change.

Even then it is not enough to have democratic mechanisms alone to thwart the most determined corruptors of capitalism. Capitalists are forever trying to use their power in government to protect their businesses against foreign competition, through higher tariffs or nontariff regulatory barriers. The Wall Street Crash of 1929 and the Great Depression of the 1930s were the direct result of such trade protectionism in the United States. The American public at the time did not vote for such policies. Indeed it voted for politicians who were seemingly opposed to trade protection.

The worst policy errors occur not because of voting decisions of ordinary people, but because politicians break their promises to the people between elections. For this reason, in the design of a democratic political mechanism for Russia, the most advanced democratic processes should be adopted, including national initiatives and referendums that can be triggered at any time between national elections in order to keep politicians from straying from the commonweal.

At the moment no such mechanism exists, but there is immediate need for economic relief. From a distance, standing outside the unfolding history of events now under way in the republics, one arrives at certain elemental considerations.

Think of the current status of Russia and the other republics as bankruptcy proceedings, the bankruptcy of the old U.S.S.R. The corporation that we had called the Soviet Union can no longer pay its bills. And, as in any bankruptcy proceeding, the creditors are crowding in to get paid, trying to elbow their way to the front of the line. There are two classes of creditors here, foreign and domestic. Thus far, the foreign creditors have been more successful, persuading first the Gorbachev government, then the Yeltsin government, to put them at the head of the queue. The government has put domestic creditors—the people of the old Soviet Union—at the end of the line.

Indeed the government has come close to advising the people that it intends to cheat them out of their ruble claims against it, their lifetime savings and pensions. This has been the advice of Western creditors, who suggest that the ruble savings of the ordinary people of the republics is a barrier to progress. They see it as a "ruble overhang" that could suddenly come out of savings for spending purposes, igniting inflation. Of course this is nonsense. The ruble savings of the people are the foundation of the new Russian capitalism and should be preserved and protected. We must include here the value of pensions, which should be restored to their level of purchasing power that existed prior to the recent inflation.

Because of the nature of the failed experiment with communism, the wealth of the nation is held collectively; a strategy must be developed that will, as equitably as possible, turn collective wealth over to private hands. The new managers of the state will, of course, try to preserve as much wealth in state hands as they can. Foreign investors will also try to crowd into privileged positions when state assets are offered for sale. It is the strength of the democracy alone that can offset these forces and place the assets where they belong, at least to begin with, in the hands of the ordinary citizens. The political leadership must be determined to place at least half the nation's collective wealth into individual hands, insisting that foreign individuals or corporations be permitted to buy assets only from the citizens in the open market. Because great wealth and natural resources are involved, it will take impressive political resolve to prevent the people from being cheated of their due through bribery and corruption. Russian capitalism must have this moral foundation.

III

Much is made by some Western analysts of the absence of the legal pillars of capitalism: courts to enforce contracts, a clear legal code, a transparent system for making regulatory decisions that affect business. This argument has great merit, because in Western democracies the state stands over the marketplace as referee, discouraging individuals from cheating one another, just as the police discourage individuals from robbing each other in the street.

Even more fundamental to the success of Russian capitalism is that the state abstain from cheating the people by demeaning the value of the currency through inflationary policies. In that regard Western democracies are not as pure as they might like to represent. If one individual owes another $100 and decides to pay only $50, the creditor has recourse to the courts to exact payment. But if the state decides to reduce the purchasing power of its currency, debtors (including the state, which is always the biggest debtor) gain from devaluation of the currency, while creditors lose. Devaluation thus redistributes wealth arbitrarily among citizens.

In Russia, where private debt does not exist for all practical purposes, the devaluation of the ruble represents nothing more than a transfer of wealth from individuals to the state. Excepting automobiles, household appliances, furniture and hoards of consumer goods, all private wealth in the republics of the former U.S.S.R. takes the form of currency or bank deposits held by individual citizens. These are debts owed by the state to the people. If the state devalues the ruble, it cheats the people out of their savings. What good is contract law or courts if the state can rob the people with impunity?

Western economists, as well as the Russian government, agree that the Russian economy can only recover if the state transfers property to the people. Under the advice of Western creditors the Russian government has gone in precisely the opposite direction. While the government negotiates with the West over $10 billion or $20 billion of emergency credits, it has virtually eliminated 600 billion rubles of private wealth through the devaluation of the currency. This savings wealth accumulated over decades in which the purchasing power of the ruble was roughly equivalent to a dollar: a dollar could buy a loaf of bread, so could a ruble. In that light the people have had the bulk of their personal wealth, 600 billion rubles, repudiated by the state. In sheer size that is an expropriation of private wealth comparable to the forced collectivization of agriculture during the 1930s. Its economic consequences are no less devastating, even though the move was accomplished without violence and deportations.

To estimate the disaster wrought upon Russia by the devaluation of the currency, we must begin with a concept that Marx omitted from his economic model, what Western economists call "transaction costs." Transaction costs are ultimately determined by the degree of risk involved in economic activity. The social cost of a commodity is quite different if a producer can sell it in a moment in an efficient market, or if the same producer must hire a dozen bodyguards to avert robbery on the way to the market. To avert robbery by the state, citizens of Russia must first convert their rubles into some store of value and then find the means to barter these stores of value for products they need. Farmers will not sell wheat or milk for worthless rubles; they would rather feed their produce to pigs, which represent an interim store of value. Thus we see ordinary citizens waiting on queues for many hours to exchange depreciating rubles for consumer goods, individuals spending hours in the market trying to exchange one good for another, and industrial managers spending weeks attempting to obtain goods they need by an elaborate chain of barter.

In a modern industrial economy whose daily activity requires a division of labor of millions of workers producing tens of thousands of different commodities, the social costs of a barter system are catastrophic; the costs of simple transactions eat up most of the economic effort of society. It is no surprise, then, that Russia is now experiencing a spiraling economic collapse, with the great majority of its citizens reduced to the most abject poverty, the diet of most citizens limited to sufficient carbohydrate calories to sustain life itself. No one believes that this situation can continue for long without catastrophic social and political consequences. It is equally obvious that the state must convince the people that it will not rob them—that it will preserve the value of its debt held by the people, for the crisis to be overcome. Once the state honors its obligations to the people, the creation of a legal code for business and related matters can be attended to expeditiously.

But how is this to be done? The state itself is in the grip of a vicious cycle: the collapse of the ruble has forced an ever-growing proportion of transactions into the barter system, wiping out government revenues. The state, in turn, is forced to print money to meet essential expenditures, since its revenues shrink much faster than it can reduce spending. By flooding the market with newly printed money, the state further reduces confidence in the ruble.

If the Russian state were a private firm within a Western industrial country, the problem would never have arisen. Russia is rich: the assets of the state, land, structures, capital equipment and mineral resources amount to trillions of dollars by the most conservative measure. Its debt totals less than one trillion rubles. Even if the ruble were valued at 1:1 to the dollar, its assets would exceed its liabilities many times over. A Western firm with such a favorable position would have no difficulty raising ready cash by borrowing against the collateral of its assets or selling some of its assets to investors. The existence of capital markets capable of converting wealth into ready cash, though, depends upon the existence of trust between creditors and debtors, something that Russia has yet to achieve.

By the most optimistic estimate Russia will require several years to privatize the bulk of state properties. It cannot exchange the state debt in the form of currency or deposits for houses, mineral rights or industrial shares quickly enough to stabilize the ruble. It must therefore persuade the people to wait for a number of years, offering capital instruments—bonds—with a corresponding maturity. The value of the ruble should be in accord with the value of Russian labor; at the current black market exchange rate a Russian worker earning the average wage of about 900 rubles a month earns barely $6 a month. Assuming that Russian labor is worth on the international market what workers earn in middle-income developing countries, the proper exchange rate for the ruble should be around two to the dollar. That should be the target for the exchange rate. The government bonds must be indexed to gold or foreign exchange at this high rate.

Russian officials worry that the people may not trust the government sufficiently to have confidence that these bonds will be redeemed at a favorable exchange rate. The building of trust is a formidable task and will require all of the state's resources to accomplish. One avenue toward that end would be to guarantee that part of a gold-indexed bond issue could be sold on international markets to Western investors. A secondary market would then exist for such bonds in hard currency; Russian citizens would, if they chose, be able to sell bonds bought with today's rubles for hard currency in this secondary market. That is an essential element for establishing trust.

It is important to recognize, though, that the state has never attempted to offer the people the chance to hold financial assets that will preserve the value of their savings. It has offered them only low-interest deposits or low-interest, long-term bonds that the public has rejected. If the government clearly explains the nature of the problem to the people and shows how it intends to make good on its obligations to the people, it still has a fighting chance to win their confidence.

Once current rubles are convertible into a financial asset that pays a dollar for every two rubles, rather than every 100 at today's distorted black market rate, a floor will be placed under the ruble's value. It is hard to tell where that floor will be, since it depends on the public's confidence in the new government bonds. Certainly the ruble's value will rise to fewer than ten to the dollar, perhaps to fewer than five. Farmers will again sell wheat and milk for rubles, rather than feed them to pigs, and a flood of hoarded goods will reappear in the stores.

These measures alone will not solve Russia's economic problems. On the contrary: they are the precondition for solving them. Russia will require the new aforementioned legal system, a tax structure that permits producers to operate with the least burdens, regulatory mechanisms that do not impede economic activity and a variety of other reforms. All these improvements are possible once a basic condition of trust is achieved between the state and the public. If the state accepts the premise that its obligations to the people are sacrosanct, Russia's leaders will have little difficulty persuading the public that all these reforms are in the general interest, since the vast majority of individuals will stand to benefit from them.

IV

It was in just this fashion that the United States began its national life more than 200 years ago. The early American experience is endlessly fascinating to today's Russian officials and opinion leaders. There were voices in the first administration of George Washington who urged a policy of debt repudiation. The new country was burdened with great debts to its own people, incurred during the fighting of the War of Independence. It also owed a large amount to creditors in Holland, who had helped finance the war. The first American treasury secretary, Alexander Hamilton, insisted this was not the way to begin as a new nation, by declaring bankruptcy, thereby cheating creditors at home and abroad. A new country should be expected to incur debt for many years before it matures and is able to redeem its obligations. The United States began on this moral principle, establishing a bond of confidence between the state and the people that became the foundation of the great enterprise that soon became the envy of the world. The new Commonwealth of Independent States will find this policy serving it just as effectively. Investment will soon flow from abroad, and from the toil of the people, as they note the integrity of the new government.

The future of Russian capitalism lies in the lessons of America's past. Honesty in its money is but one element. Simplicity in law is another. In the United States more than 700,000 lawyers ply their trade, draining off the energies and talents of a nation in empty legal skirmishing. Battalions of accountants are required to fathom the dispiriting intricacies of the tax laws. Bank regulations have become so incomprehensible that ordinary people increasingly find it impossible to borrow. The government has become dominated by aging capitalists who add layers of complexities to prevent new competition from below. The freedom and flexibility of America's youth has become bound like Gulliver.

If Russia is to leap ahead after 75 years of stagnation it should be resisting all advice that comes from the West that complicates growth. Americans can now only dream of how nice it would be to start anew, with a blank slate on which we could write simple tax and regulatory legislation. Complexity serves the interests of the elite, who know how to pay their way around it. It confounds the interests and opportunities of ordinary people who are hoping to get ahead. If Russia can think of itself as a nation of young capitalists, striving to attain a potential that now seems limitless, the path to its prosperous future will more easily be seen.

Two centuries ago the elite of the Old World looked smugly on the ragtag enterprise of the new United States of America. We can be sure there were many who doubted whether Americans would ever amount to much. These Americans would surely be confounded by the wilderness, the native savages, and the absence of experienced institutions capable of dealing with the intricacies of modern politics and commerce.

We Americans, in turn, may now be tempted to become Old Worldly ourselves, viewing the new Russian enterprise with patronizing amusement and skepticism: it will surely take these Cold War losers a generation or two before they learn the sophisticated nuances of modern business and finance, to the point where they will understand the profound importance of a leveraged buyout. Will it not?

Or perhaps we could consider the Commonwealth as a kind of new frontier, an adventure on the planet that will soon be exploring far more interesting possibilities than leveraged buyouts and convertible debentures. Across the great expanse of 11 time zones, Russia and the republics are like so many liberated colonies, freed of the straitjacket of the communist idea. We should not forget that the idea was simply one that subsumed individual risk-taking and reward to the security of the community, the commune. The experiment in political economy did not work, and the people who were subjected to it are eager for a system that will.

If our own history is any guide, we should expect in this brand new country an eagerness for opportunity and an explosion of risk-taking and entrepreneurial ferment. The people of Russia clearly look to the United States, not Europe or Asia, as the exemplary model. We should be happy they do and counsel them in that spirit, not as old adversaries or potential new competitors, but as converts and potential new allies. It will make a great difference to the shape of the 21st century.