Pathfinder

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AN ECONOMIC ANALYSIS OF GORBACHEV'S REFORMS

Two basically naive questions have dominated our discussion in the West about the causes, implementation and effects of economic reform and *glasnost* in the Soviet Union: "Does Gorbachev mean it?" and "Is Gorbachev going to be able to pull it off?" The first question calls for an opinion on Mikhail Gorbachev's integrity. The second question is about the balance of power within the Communist Party. In addition, many intellectuals in the West support Gorbachev's reforms. The argument is that reforms are supposed to increase the standard of living in the U.S.S.R., open new horizons for the Soviet consumer and, consequently, pressure the government into substituting butter for guns. This is a *non sequitur,* a conjectural and dangerous argument. As long as the Soviet Union is a policy state and the communist ideology is its major export, the West should be better advised to support policies that promise to destabilize the communist rule in Russia.

The crucial question about the Soviet reforms is: How can we tell whether economic reforms are being implemented? Thus far, Gorbachev's rhetoric about economic reforms and *glasnost* has consisted of declarations of intentions, a strong emphasis on changes in manufacturing (the most powerful center of planning bureaucracy), limited criticism of bureaucrats that he wants to replace anyway, and more lenient policies toward dissidents. Gorbachev's rhetoric has softened the West while the Warsaw Pact military forces are gaining in strength, provincial leaders are being replaced by Gorbachev's proteges from Moscow, and East Europeans are warned not to go too far with their reforms. We still lack evidence that Gorbachev means what he has been saying. Yet, Western media has shown more confidence in his political pronouncements than in Oliver North's statements under oath.

Oleg Bogomolov, a senior economic adviser to Gorbachev, said in a recent interview, "We need market competition to produce better products, eliminate monopolies, improve the performance of enterprises and increase the efficiency of investments." Given this astonishing discovery of a leading Soviet economist, Gorbachev proceeded to say at the 27th Party Congress that the role of central planning is to be strengthened while the enterprises are given more freedom from the center. How he plans to reconcile those two contradictory goals remains to be seen.

The blueprint of proposed reforms was published in Pravda on June 27, 1987. It is perhaps the most important document we have for judging Soviet intentions. The document is a typical committee product. It is full of contradictory statements, sophomoric economics and obvious political compromises. For example, the document says, "It is essential to abandon administrative and high-handed methods and move on to economic management methods," and then, "the attainment of strategic goals of the economic policy of the Communist Party calls for the creation of a central guidance system...with the use of all economic levers: plan, financial control, prices...."

The document suggests that economic reforms in the U.S.S.R., if implemented, would

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neither replace the old institutions nor modify them. They would merely introduce into the Soviet system a new set of institutions to coexist with the old ones. The authors conjecture that the implementation of the blueprint of Soviet economic reforms would seriously destabilize the Soviet economy. Assuming that an objective of our foreign policy is to reduce the Soviet ideological and military influence, the West should encourage Soviet leaders to proceed with proposed reforms.

It is quite important for policymakers in the West to be able to determine whether the Soviets are implementing economic reforms or just talking about them for domestic and foreign benefits. Economic analysis tells us what to look for.

The Soviet manager's job, promotions and future income depend on his firm's fulfillment of the production plan. Economic reforms would change the manager's incentive structures. His rewards are proposed to be linked to the profitability of his firm. This is easier said than done. The implementation of the reform would require a series of institutional changes in the Soviet Union. In particular, the prevailing property rights in capital goods would have to change.

In the Soviet Union, the state allocates capital goods to business firms, transfers them (via administrative edict) from one enterprise to another and determines the pattern of net capital formation. The Soviet firm cannot sell, rent or modify capital goods in its possession. It can only use them to produce (and overproduce) its prescribed output target. The firm is not charged from the use of capital goods. Predictably, the Soviet manager considers capital goods as a *free reserve.* There is no penalty for having too much capital (relative to the firm's output target) and it could be useful in case of breakdowns or other emergencies. Either through successful underreporting of their firms' production functions or through political pull, many managers have ended up holding an excess of capital relative to their prescribed output targets and true production functions.

By making the manager's rewards depend on the firm's profitability (defined as the ratio of profits to the book value of the capital stock) economic reforms would radically change the role of capital in the Soviet firm. The Soviet manager would suddenly face a totally different game. From being an asset, "accumulated reserves" of capital would become costly to hold. The manager would have strong incentives to seek to minimize his firm's needs for capital. To make the concept of profitability operational, the Soviet government would have to grant the Soviet manager some definite property rights with respect to the allocation and use of existing capital goods.

The Soviet manager today is only too happy to have his worn-out machines replaced by whatever else he is able to get via administrative channels. The emphasis on profitability would change the manager's attitude toward replacement capital. He would become more discriminating with respect to the quality of replacement capital and press for some rights to control it.

Finally, the implementation of economic reforms must give the manager some property rights in controlling the quality and quantity of new investment. Otherwise, the emphasis on profitability as a vehicle for more efficient allocation of resources will not get off the ground.

The point is that the Soviet watchers should be less concerned with Gorbachev's speeches and more interested in what the Soviets are doing. If and when the Soviet government begins to transfer property rights in capital goods to business firms, the implementation of economic reforms will be on the way. As long as property rights in capital assets remain what they are today, Soviet economic reforms should be treated by our policy makers as a facade of words. To implement economic reforms, the Soviet government must give business enterprises some definite property rights with respect to the allocation of existing capital assets, replacement capital and net capital formation.

—Charles Maurice
Steve Pejovich

Dr. Pejovich is awarded the Texas Education Agency's Certificate of Appreciation by Texas Commissioner of Education Dr. Bill Kirby.

TRADE BILL IS HAZARDOUS TO CONSUMER HEALTH

The worst anticonsumer legislation in decades soon will be approved by Congress. Subsidies will be lavished on every industry with enough organization and money to buy the votes of a few legislators. Through the well-known process of mutual back scratching, a few congressmen can roll up enough votes to get the taxpayers to ante up for their supporters.

The legislation is called a trade bill, to be precise, the Omnibus Trade and Competitiveness Act of 1987. It has some provisions affecting trade rules and regulations. Those are a small part of the bill.

Is Congress interested in consumer health? Why does the trade bill give additional subsidies to the already heavily subsidized tobacco industry?

Bill Is a Christmas Gift

Is Congress concerned about the costs consumers pay for clothing? Why does a companion bill extend and intensify the virtual ban on increased imports of textiles, apparel and shoes?

These examples of anticonsumer legislation are only two of many subsidies, prohibitions and tax rebates that will be paid by consumers and taxpayers now and in the future. Most of the trade bill is a Christmas tree with gifts for special interests. The gifts often have little to do with the trade problem or the lack of competitiveness of the American economy about which congressmen like to talk. Gifts for sugar, wool, lamb and sunflower seed producers are in the bill, along with subsidies for computer chip makers, some steel producers and many others.

Direct costs of subsidies, taxes and tariffs are only part of the costs consumers will pay. Protection here encourages protectionists abroad. If we restrict Brazilian shoe exports, Brazil will intensify protection against our computers. Restrictions against Canadian wooden shingles bring Canadian restrictions against U.S. farm exports. New trade restriction not only raises the costs to consumers directly but, by encouraging retaliation, reduces the markets for U.S. exports.

There are more subtle, but not less important, effects. Protection of the steel industry for more than a decade kept the price of steel used by U.S. producers higher than the world price. Instead of importing steel to lower the cost of producing automobiles, tractors, machine tools and other products made of steel, we imported autos, tractors and machine tools.

Protection didn't strengthen the competitive position of industries that use steel. These industries became less competitive and many of them demanded protection in turn. Consumers paid more for the cars, trucks and other durables made with steel. Imports helped to lower these prices, but restrictions on imports worked against lower prices.

We all buy imports if they give us better quality or lower prices. The appeal of Japanese or Korean cars and consumer electronics is the same as the appeal of Asian apparel, Italian shoes or American medicines and computers. Trade benefits consumers, and trade restrictions hurt.

Years of Protection

How are Americans hurt by imports? The consumer who buys a foreign car or a T-shirt made in China thinks he has made a wise choice. If an American producer offered a product with as good or better quality, price and service, he would get the business. Protection gives him the business, or more of it, without encouraging him to lower his price or improve the quality or service he offers.

The American steel industry has been asking for, and receiving, increased protection for more than a decade. If protection worked to improve quality and lower costs and prices enough to make the industry competitive, the steel industry would be booming. It is not.

Advocates of the trade bill portray the United States as a crippled giant, unable to compete in the world. This is nonsense. Judged by our ability to export, we have done very well recently. Exports increased by 20 percent in the year ending in July when measured in constant dollars. This is the highest growth rate in a decade. Imports, though still rising, are rising much more slowly than exports. Export growth is, again, a mainstay of growth in U.S. output and standard of living. If we can scuttle the trade bill, exports will continue to grow.

America's competitive position in the world does not require special interest legislation posing as protection. Our ability to compete depends mainly on our productivity, the wages we get for the work we do, and the way we use our skills and talents. Productivity depends on the quality of the tools and machines we work with.

Exports for Imports

Congress could improve our competitive position by changing the tax laws to increase investment in new machinery, new tools and new plants. The 1986 tax bill shifted more than $100 billion in taxes from individuals and households to businesses. Many of the higher business taxes fall on business investment. Less business investment means poorer future productivity performance by American industry. Lower productivity growth means slower growth of real incomes and living standards.

Over the long term, we pay for our imports with exports. Neither the trade bill nor a tax bill can affect that. We can affect the quantity and the quality of the goods we export and the standard of living at which we live.

The trade bill lowers our standard of living by subsidizing the domestic production of goods we can buy more cheaply elsewhere. Policies to encourage, but not subsidize, investment raise our standard of living.

We often forget that the object of the competitive struggle is to raise standards of living in the world, especially our own. The protectionists in Congress have either forgotten that message or never learned it. Under the guise of protecting us, they are penalizing us—all of us. Consumers must ask themselves and their congressmen, who or what is being protected, and who will pay for it?

—Allan Meltzer

ALLAN MELTZER is the J.M. Olin Professor of Political Economy and Public Policy at Carnegie Mellon University. This article was written for the Los Angeles Times.

STOCK PRICES AND "PAPER LOSSES"

The major concern of most people about the recent stock market crash is, "Will it cause a recession or a downturn in the economy?" Ironically, an important factor working against the crash causing a recession is a serious misconception about the implications of the plunge in stock prices.

How many times have you read or heard such statements as: "They were only paper losses. It was paper when stock prices went up and it was paper when they came down. People were playing with Monopoly money. Easy come, easy go." Such statements are not only wrong, but they also may cloud the real economic repercussions of the decline in stock prices.

Many people seem to think that because stock prices were pushed so high during the bull market, the fall was merely a return to the status quo and, especially for those who haven't sold their stock, does not represent a real loss. These people couldn't be more wrong. Declines in the value of stock represent real losses of wealth and purchasing power both for stock owners who stayed in the market and for those that sold stock during the crash.

Consider one extreme example of only a "paper loss." Suppose that you find \$100 one morning. On your way home that evening someone steals the \$100. Is your loss of the paper a real loss? Of course it is. You are poorer by \$100 than you were before the theft.

Gains and losses in the stock market have exactly the same effect. Consider two people with exactly the same portfolio of stocks. Both sold their stocks and put the money in the bank. The difference is that Smith got out of the market on Friday, October 16, while Jones sold out the following Monday. Who has more money in the bank? Who can buy more cars, more clothes, more vacations, more anything? Jones cannot buy as many goods and services as Smith can. Jones has less wealth and, consequently, suffered a real loss on Monday.

Someone might ask instead about Brown, who chose to ride out the market and didn't sell. So Jones suffered a real loss, but isn't Brown's loss only on paper? No, because Brown's wealth or ability to purchase goods and services depends upon the value of the stocks, i.e., how much Brown would receive from selling the stocks. When they went to bed Monday night, both Jones and Brown could purchase fewer goods and services than Smith—both had experienced the same decrease in wealth. Jones' remaining wealth was in the bank. Brown's remaining wealth was still in stocks. Since each lost the same amount, neither of them probably slept very well.

The fact that stock market losses are real reductions in wealth and not just paper losses is not merely a matter of semantics. The distinction is important because changes in wealth typically affect spending patterns. When people are (or feel) wealthier, they usually spend more. When their wealth decreases, they generally cut back on spending. So any losses in wealth that translate into reduced spending will have real economic consequences. If stockholders believe they have experienced significant declines in their wealth, they will probably think harder about buying a new car, taking an expensive vacation, remodeling the kitchen, and so forth. How the decline in the wealth of stockholders affects their spending and saving will have a significant effect on the economy.

Although the stock market losses were real to those who owned stock, whether they sold it or not, the fall in stock prices did not affect the amount of capital stock, the number of skilled workers, or the quantity of any real productive resource. So a change in stock prices does not affect productive capacity in the short run.

The resulting decline in people's real wealth could, however, seriously affect the extent to which these resources are utilized and, therefore, have real economic consequences. If people feel poorer due to the steep decline in stock prices, then consumer spending will decrease. A large reduction in spending would lead to the recession that many are predicting.

If the decline in stockowners' wealth causes many people to reduce their spending and cancel their investment plans, less goods and services will be purchased. Or, people who lost wealth in the stock market may, in fact, believe that these were only paper losses. They may believe that the loss in wealth was only a loss of the gain from the previous bull market and, therefore, only a paper loss. If this is the case, they will continue spending the same as before.

How the decline in stock prices will affect spending and the performance of the economy depends also upon how it affects the confidence of consumers in general. If many people, who did not own stock, become less confident about the economy because of the stock market, consumer spending will fall. Or, if the typical consumer believes that only the rich were hurt by the stock market dive, or that these were only paper losses, and continues spending as usual, the losses in wealth will have a small effect on the economy.

The keys to assessing the real economic consequences of the decline in stock prices are first how the spending of those who lost wealth is affected and, second, the extent to which consumers' confidence in general has been shaken. It is, therefore, possible that the widely held belief that stock market losses are only paper losses, which is not true, will forestall a large decrease in consumer spending and a resulting economy-wide recession.

—Niccie L. McKay
Charles Maurice
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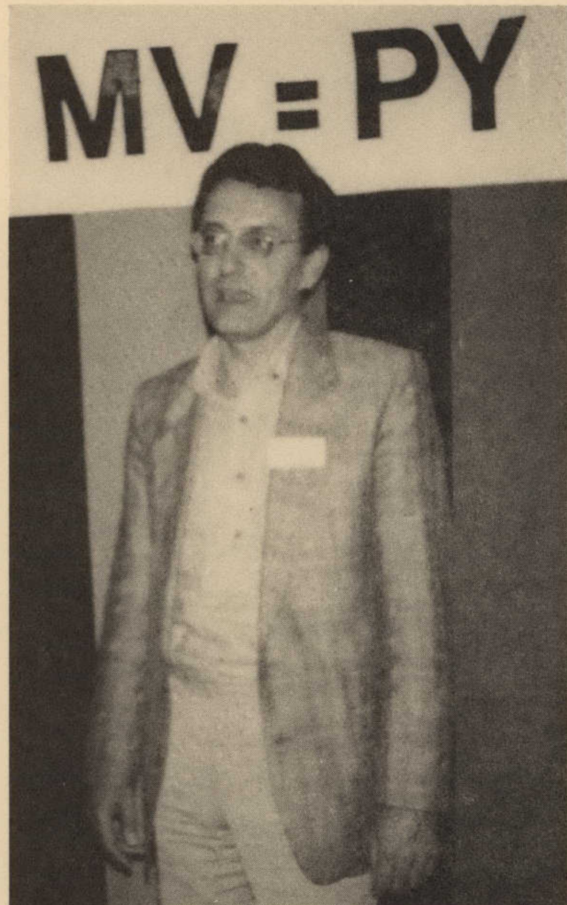
U.S. Sen. Phil Gramm, a member of the center's National Advisory Board, has received the American Security Council's 1987 National Security Leadership Award.



Distinguished visitor Dr. Manfred Neumann, a leading European economist and professor of economics at the University of Bonn, visited Texas A&M during November. In addition to giving a seminar, Dr. Neumann visited the center and met with its directors.

THE DIRECTOR ON THE ROAD

Dr. Pejovich was invited to participate in the Conference on Privatization organized by the William E. Simon Graduate School of Business Administration, University of Rochester. The conference was held in Washington, D.C., November 6-8.

• A session on Law and Economics was chaired by Dr. Pejovich at the Southern Economic Association meeting in Washington, D.C., on November 23.

• Dr. Pejovich presented a paper, "Innovation and Property Rights," at the American Economic Association meeting in Chicago on December 28.

• New Publication: Dr. Timothy Gronberg, associate professor of economics at Texas A&M University, has just published an important work: *A Privatization Primer*. It will be released as part of the center's Public Issues Series.

• Deadlines for the Olive W. Garvey Fellowships for the 1988 General Meeting of the Mont Pelerin Society (Tokyo/Kyoto, Japan, September 4-9, 1988) have been announced. The fellowships will be awarded for the three best essays on the topic, "Toward An Open World Order." Essays of not more than 5,000 words may be submitted by students or faculty members 35 years of age or younger, who are not members of the Mont Pelerin Society. The essays will be judged by a panel of the senior members of the Mont Pelerin Society. Deadline for submission of essays is March 31, 1988. The award will be part of the cost of attending the Tokyo meeting in September 1988.

For further information, contact the Center for Education and Research in Free Enterprise.

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NATIONAL ADVISOR GETS GRANT

Dr. Karl Brunner, a member of the center's National Advisory Board, has been awarded a substantial grant from the Lynde and Harry Bradley Foundation, Inc. of Milwaukee, Wisconsin. This grant will enable Dr. Brunner to focus on research and teaching of the impact of public policy issues on the economy. Simon School Dean Paul W. MacAvoy announced that Dr. Brunner's Center for Research in Government Policy and Business will change its name to the Bradley Policy Research Center.

AN AGGIE INTERN IN D.C.

Jody Manley, a senior journalism major and associate of the center, spent the summer as an intern in Washington, D.C.

Manley participated in a program that trains journalists in research and evaluation of issues and helps place graduates of the program in all areas of journalism. It is sponsored by M. Stanton Evans, chairman of the Education and Research Institute.

The program is divided into two parts: an outside assignment and an inside assignment. Inside, interns choose a topic, research it and write what is called an "Issue Brief." Research is heavily emphasized. Interns don't just become familiar with their subject, they become experts on it.

For their outside assignment, the National Journalism Center matches the interns' career objectives with a journalism institution. Places include Evans and Novak, *Washington Times*, Radio America, CBN and the Berns Bureau, among others. The whole program permits interns to see how journalists, politicians and other institutions work together or against each other in setting the public policy agenda.

A seminar is given each week so that the interns can learn from professional journalists such as Ralph Bennett, Bob Novak and Stanton Evans. Bennett reveals his philosophy of "strategic journalism," which includes looking "for the enduring reality of the event" and knowing the subject. Novak emphasizes accuracy in writing, while Evans lectures on the importance of economics.

LONG QUEUES, SHORT TEMPERS

By the year 2000, the U.S.S.R. will have consumer goods in abundance, promises Mikhail Gorbachev. Meanwhile, there are queues. According to *Izvestiya* (October 24, 1987) "the queue has become the very symbol of our life." The stream of readers' letters on this sore subject has not diminished.

From Ufa (population 1,077,000): "There are not only queues for sausage in our town, but also for every little thing, everywhere, at the polyclinic, chemist, post office, savings bank, and for town transport. Almost all the time free from work is passed standing in queues. No one takes this time into consideration, no one takes it into account. It is actually a peculiar form of additional payment for purchases."

A Moscow reader points out that the need to take time off work for shopping is a major factor in lowering productivity. A reader from the Industrial District, Dnepropetrovsk, has been on the housing list since 1977—along with more than 1,300 others—and the queue has dropped by only 30 in the course of a year.

Bad organization was another reason for queues. A so-called self-service store has only sugar and cereals prewrapped. Fruit and vegetables are so horrible that "one does not want to look at them, let alone buy them." There are three shop assistants, but only one set of scales....The town authorities do not improve matters "because they themselves do not stand in queues."

From Chelyabinsk (population 1,107,000): "The whole week we work in the fields in the pouring rain. On Saturday we go shopping and are told there's nothing to be had: no washing powder, toothpaste, soap, butter, vegetable oil, margarine, sausage. Or if something appears, there is such a queue that you cannot get near." The writer accuses the local authorities of not paying any attention to the suffering of ordinary people.

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