The “Forgotten Lands”: An Institutional Analysis of Post-Soviet Transitions

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Abstract

This inquiry provides an institutional critique to the analysis of the post-soviet transition. It seeks to demonstrate that: an absence of a thorough institutional analysis, unrealistic marketization programs, conflicting ideological perceptions for the role of the state, and persistent systemic problems of state planning have constituted significant constraints to the transition away from the soviet style planned organization of production and distribution. Preservation of the soviet mode of production, in turn, inevitably led to a fundamentally flawed policy approach and guided the former Soviet bloc toward an unproductive and damaging path-dependence. This path-dependence contributed to retarding the process of cumulative causation and capped the influx to the joint stock of knowledge, both of which remain crucial for progressive institutional adjustment.

Keywords: institutional adjustment, path-dependence, planned economy, soviet mode of production, transition economies

JEL Classification Codes: B15, B52, O4, O19, O21, P21, P30

Introduction

After the collapse of the Soviet Union at the beginning of the 1990s, centralized planning and state ownership of the means of production were blamed by many economic theorists for driving the disintegration of soviet socialism. As a result, it was advised that the newly emerged independent economies immediately switch to free markets and private property. Based on the idea of efficient and self-regulating free markets, crude implementation of market reforms occurred throughout the post-soviet arena.

While some countries have minimized the negative spillover effects of such drastic institutional shocks, others have found themselves in downward spiral growth trends that Bogdankiewicz (1993, 340) associated with a sharp increase in unemployment rates, hyperinflation, bankruptcy of massive state enterprises associated with the institutional crisis, and unsustainable foreign debt burdens. Rapid growth of consumption, rising inflation, and low levels of gross investment prevented the needed expansionary policy to promote basic capital reproduction and its technological renovation.

This inquiry argues that a successful completion of the transition process is constrained by the prevailing institutional structure and technological organization, both of which require a set of reforms targeted at the dynamic transformation of sectoral organization with conducive macroeconomic conditions and financial stability. To this purpose, this essay investigates the inherent problems in the physical production process of soviet-style economies and offers the appropriate method for assessing the institutional organization of a centrally-planned production process.

Soviet mode of production

Gehrke et al. (1992) and Edward Nell (1993) recognize that major economic problems with a soviet style economy are related to extensive as opposed to intensive output growth and a seller's market as opposed to a consumer's market. The roots of these economic phenomena lie in the underlying policy strategy directed towards satisfying the basic social needs which serve to maintain the power dynamic of the prevailing political regime.

The production process in a soviet style economy is not only planned and strictly supervised by the state, but it is also predominantly financed by government expenditures given that the size of a private sector is insignificant even in the modern day[1]. Investment spending primarily comes from the state, which means that the production strategy is not profit-driven. This creates a set of perverse incentives for any enterprise willing to engage in the production process, regardless of how risky it may be considering the soviet tradition of production finance.

When the level of investment exceeds a technically feasible level, it requires an ever increasing investment share to maintain growth. But according to Mark Knell and Christine Rider (1992), maintaining extensive growth and suppressing inflationary pressures leads to a continuous drop in the potential capacity. As a result, bottlenecks occur. This further intensifies the problem of shortages, creates supply distortions over time, and lowers growth rates as a whole. Furthermore, given that the economy is at full capacity[2], there is no room left for necessary adjustments because of planning mistakes—neither at the aggregate level, nor in terms of re-switching the proportions of output.

Although highly controversial among economic theorists, the Post-Keynesian approach posits that the inflation level is supply-driven in a capitalist economy, while it is demand determined in a socialist economy. Maintaining a high nominal wage rate is yet another task for state planning since providing basic needs is one of the fundamental roles in a socialist state. Nell (1992, 93) emphasized that in a socialist economy, wages tend to drift upwards while prices are held as low as possible; whereas under capitalism, nominal wages are kept as low as possible, while prices fluctuate with an upward trend. Ultimately, socialism lets the wage level increase in order to achieve social and political objectives.

Following Knell's analysis (1992, 10), there are three types of prices relevant to market-oriented transition states—market price, administered price and natural price. Due to permanent shortages, the market price will usually be above the administered, which provides an incentive to enter the market even if the administered price is above the natural. In this case, however, planners will be forced to lower the price level. Lowering the price level or repressing prices to rise, in turn, results in suppressed inflation, providing a negative feedback to investment and growth trends:

[1] With exceptions of larger higher-income economies like Russia and Kazakhstan.
[2] Creating an illusion of full employment

> The high investment program, which results from the fact that all these economic plans are connected with a political decision of industrialization at a rather speedy rate, produced everywhere an inflationary gap which is being solved in some constant pressure of excess demand in all markets, which in turn, creates a situation that any increase in output, in whatever field, appears as a desirable thing (Lange 1949, 167).

As pointed out by Nell (1992, 86), under socialism the efficiency and productivity of the inputs are assumed and investment is planned in order to reach the highest expansion rate consistent with planned consumption. This means that it is not only supply that is controlled by the state, but also demand that is generated by the system that is continuously fueled by over-investment. Douglas Brown (1988) appropriately reminds that the Budapest School emphasizes this privilege of defining public's needs as a uniquely repressive posture. However, when a large share of national income is devoted to public investment, it leads to distortions in the supply of consumer goods, which results in constant pressures of excess demand as the consumers' needs are essentially ignored. Resulting shortages eliminate the incentives for an enterprise to improve quality, productivity levels, or to decrease costs, since there is no uncertainty about having the market for their output—the market will always be there. Engaging in such a production strategy means that, within limits, anything produced in the economy will be absorbed by the market.

Market reforms solution

Based on the idea of efficient and self-regulating markets, a series of market reforms (in the form of gradualism or shock therapy) had been implemented throughout the newly independent soviet states during the 1990s in order to resolve the inefficiency problems of lagging economies. But newly emerged post-soviet economies did not have a proper institutional setting for such abrupt changes. The idea of market reforms as a suitable means for reorganization of the production process takes its roots from the neoclassical model and its view on the efficiency of property rights that has been universally promoted by regulations of the Washington Consensus. While on the contrary, the dominant rights system with its state-owned enterprises was considered an inefficient model mainly due to a principal agent problem caused by asymmetric information.

Institutional reorganization plays a primary role in a transition to a different mode of production. The lack of market mechanisms, poor knowledge of available technologies, and a rigid nature of the production process did not fit the universal framework of the International

Monetary Fund's marketization plan with its strict unrealistic set of institutional and behavioral assumptions necessary for a continuous market clearing mechanism. As pointed out by Hagemann and Kurz (1990, 743-745), it is the social structure that engenders different motivations and behavioral patterns; and it is this existing social structure that acts as a constraint to developing a new growth path.

Market reforms served a clear ceremonial function in bringing nations away from the socialist mentality: it served as an attempt to corrupt the existing set of ceremonial values. The degree of past-binding ceremonial dominance was overlooked in favor of focusing solely on the efficiency of instrumental feasibility. The transition to market policies ignored the significant impact of ceremonial encapsulation; rather it focused solely on blind imitation of instrumental behavior borrowed from other nations developed under a different set of institutions.

Ceremonial habit is part of the social fabric and as such requires attention when seeking recognized interdependence and locating the bounds of minimal dislocation. This change, if accomplished, functions in accordance with the principles of institutional adjustment (PIA) as put forth by Foster (1981) and Bush (1987). The principle of technological determination suggests that an institutional structure must coincide with the instrumental capabilities of the system. Technological determination provides us with a new set of available behaviors. The principle of recognized interdependence reinforces the idea that a new type of behavior must be directed and mechanized since it only becomes habitual through repetition. Foster emphasizes that "conceptual apprehension precedes the course of action differentiating the new pattern from the old" (Foster, 933). Finally, the principal of minimal dislocation defines the limits of the adjustment process and states that any modifications must be approved by the existing institutional structure. If they are not, then society can eliminate changed patterns inappropriate to the problem-solving process.

While the "data" required by the first PIA was provided, it failed to coordinate the "instrumental functions at a level of efficiency tolerable to the members of the institution" (Foster 1981, 935). The second principle was violated because there was no plan of corresponding renovation of the economic sector based on the new policies. The reforms were largely abrupt and chaotic, which could not provide the required level of mechanization. Most importantly, the market reforms failed to selectively target only those factors that were considered problematic to the society which clashed with the ceremonial dominance of the soviet habits.

Among many others, Adolph Lowe continuously challenged the Pareto-Walrasian approach to economic analysis. His theory emphasizes that the mainstream theories approach completely ignores the rigidities of modern industrial structures and the diversity of individual motivations and expectations. He suggests an alternative approach—instrumental analysis—that calls for institutional reforms as a basic instrumental tool (means) to create a "goal-adequate" climate for a new economic regime. The essence of this approach boils down to establishing the ends-to-means relationship properly. Lowe (1976, 11-12) reverts the traditional causality logic by stating that one must find suitable economic means (treated as unknowns) in order to achieve any stipulated ends (treated as knowns).

Market socialism

The disappointing results of the market reforms animated the revival of central planning and state control over distribution of goods; while further consolidating the old soviet institutional structure and momentarily relieving some of the havoc spurred by market reforms. This path-dependence has contributed to retarding the process of cumulative causation and capped the influx to the joint stock of knowledge, both of which remain crucial for progressive institutional change as explained by Foster.

Abrupt unregulated price liberalization, stripping of the public goods sector, and mass privatization of state enterprises failed to address the lack of demand. Additionally, the involvement of an economy with market-oriented nations required the development of a relatively sophisticated financial structure, for which the rigidities of a soviet institutional system were not suited. Mishandling of the financial sector has created an unstable economic environment in already fragile transition economies. External debt issues, in turn, restrict the domestic sectors ability to improve unsustainable debt ratios and overall economic development by generating accruing financial fragility.

The idea of market distribution was appalling to the soviet mentality which was used to viewing the state authority as the ultimate troubleshooter. The command system, however, sought to guarantee the economic and social equality of economic agents, because it granted the right for everyone to remain within the production process and satisfied basic social needs creating a sense of stability and security free markets would not tolerate. But this came at a cost of maintaining the dominance of the political power held by government elites.

Gehrke and Knell (1992) emphasize that selecting an appropriate structural adjustment path must consider that the range of feasible transition paths is constrained by the prevailing social and technological structure. These changes, in turn, induce motivations and microeconomic behaviors compatible with the desired goals (such as increasing efficiency and productivity without having to face the infamous deadly faults of capitalism). Hence, it is appropriate to conclude that the process of institutional adjustment should have served as a means to achieve the desired "goal-adequate" environment. However, the ideological frictions about the usefulness of centralized planning and its ability to maintain social stability after the failed attempts of reorienting to "free markets" further retarded the needed transformation.

To force one to stop thinking about the old habits, the new unaccustomed actions must be different from the original ones, otherwise, it becomes likely that the actor will fall back into the old state of habits. Here, the market reforms were implemented as crude instruments with the main purpose of eradicating the soviet system and to fully deracinate the soviet mentality. This, in accordance with John Dewey (1922), was a fatal failure in attempting to change the soviet habits; since this particular action was not disconnected from the past ones, it continuously elicited previously established habits from the socialist system.

Instead of dismantling the entire system of planning, it needed to be restructured. Instead of engaging in a vast limitless privatization process, hoping for the magic features of private property, soviet institutions needed to be reorganized and supervised. Forstater (1997) suggests that the key is to find a balance consistent with the existing value structure between the necessary public sector activity and discretionary public sector involvement. Market forces and central planning elements should have been recognized as complements in order to make the transformation process smoother. Central planning should be complemented with the market practices in order to modify the incentive structure by directing the production mechanism to profit-based autonomous spending which drives income growth (following Eichner, Kalecki, Kregel, etc). As new institutions are introduced, the former social context in which microeconomic behavior is formed is then dissipated in a profound way. Appropriately dealing with this disturbance requires a significant degree of flexibility, which is a very desirable feature of any economic system as the lack of such causes sluggish growth, inflationary pressures and bottlenecks[3].

In addition, a typically authoritarian government puts an effort into suppressing the knowledge inflow to a given stock of knowledge because this will consequently require an institutional adjustment, lowering ceremonial dominance, which will diminish the degree of authority. Hence, ceremonial encapsulation deprives the community of higher levels of instrumental efficiency. James Sturgeon (2014) asserted that such conservation of soviet habits conforms to Dewey's idea that force only suffices to return a previous order of things and to restore familiar behavioral patterns; it does not bring change.

This, however, does not mean that it is impossible to improve the institutional organization of society in a way that will promote dynamic technological changes. The key is for every individual to have the ability to non-invidiously participate in modifying the existing institutional structure. Marc Tool affirms that "so long as democratic means of deliberation and social action are available, the community is prompted to continue its experimentation with alternative institutional forms until the most efficient options, on present warranted knowledge, are chosen" (2000,103). This means that a democracy is needed as it functions as the only organization of a community that does not promote ceremonial judgments, preventing proper adjustments desired by the community. Such a claim, however, does not imply that the process is not feasible in the environment of centralized planning. As Knell (1992, 18) asserts, a transition of a soviet economy requires changing the nature of the role of state to the one that is oriented toward incentive based instead of directive planning and democracy instead of despotism. One can conclude that the key for a terminal state of the soviet economy on its transition to a market-oriented economy is to find equilibrium between freedom and order.

Conclusion

Despite multiple attempts to adjust to a market economy, values of totalitarianism still play an important role in most of the former USSR economies after numerous trials of economic and political transformations for almost two decades. Attempts to improve economic growth and living standards often turned out to be counterproductive when policy's targets were

[3] As defined by Forstater, flexibility is "the elasticity of the production system, the adaptability of the production system in the face of structural and technological changes, such as capital or labor-saving technical innovations, changes in labor supply or the supply of natural resources and changes in the composition of final demand" (1997, 1).

misspecified or bounded by external forces like international financial institutions. This paper demonstrates that the key to a successful completion of a transition process is a combination of policies targeted at the dynamic transformation of institutional organization with conducive macroeconomic conditions and financial stability.

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