

# Russia, 1992: the making of an economic catastrophe\*

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According to Moscow's Independent Newspaper, even before the most recent price increases, the rising cost of basic provisions had already returned the real incomes of Russian urban consumers to the level of just after World War II. "We live as we did 45 years ago – maybe worse."<sup>1</sup>

In wealthy industrial countries, great economic disasters come rarely, at least in time of peace. The early 1920s saw hyperinflations throughout central and eastern Europe; like the present-day Russian inflation, these were associated with sudden political openings following the collapse of the German, Austrian, and Russian imperial bureaucracies; but they also unfolded against the backdrop of recovery from a Great War. This time round, there is no such excuse.

To understand the Russian economic disaster means first of all to understand the old, Soviet economic system. And it is important to stress that to a large extent we are witnessing still, in 1992, the working out of the last, worst tendencies of the old system as it continues to decay. Russian citizens are sometimes quoted to the effect that now they understand the market economy is not a paradise, and that capitalism has its unacceptable face. Maybe so – but the Russian disaster cannot yet be understood in terms of capitalism or the market, since so far there is neither a real market economy, nor real capitalism, only at most the law of the flea market.

## Building socialism

Right from the start, the Soviet economic system was aimed at social and economic transformation. Lenin and after him Stalin inherited a relatively backward, largely agrarian economy with limited development of modern industries and railway transport. The Stalinist elite, formed in the 1920s, was determined to refashion it into a modern industrial state with high levels of literacy, productive capacity and defensive might. The chosen means of transformation was the

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<sup>1</sup> *Nezavisimaia gazeta*, 16 January 1992.

building of an entirely new capital stock and infrastructure under public ownership – industrial factories, new towns, power grids, transport systems, a mechanised army. Thus, “building socialism” was meant quite literally, and was carried out with bricks, mortar, and structural steel.

The economy of the Five Year Plans was biased towards rapid expansion. This bias was expressed not only through the speeches and campaigns of political leaders who periodically set out ambitious goals for an urban, industrial utopia, but also through permanent bureaucratic rules which imposed steadily rising quotas of output upon socialist firms, and rewarded them for meeting these quotas, regardless of cost.

Rising output, regardless of cost – here was the preference for expansion over efficiency. To the central decision makers, it always appeared better to increase capacity, regardless of efficiency, than to achieve greater efficiency at a lower level of output. Loss making firms were never closed since at least they increased total output; better to restructure them, than to waste the capital and labour resources employed in them through bankruptcy and redundancy. Loss, not profit, became Moscow’s signal to invest. The same higher authorities also enjoyed great discretionary control over resources, since they were not fettered by efficiency considerations. Moreover, the commitment to this system found at higher levels was matched in factory offices and on the shop floor. Firms’ managers and workers also benefited from the system; they had little control over management decisions, but they enjoyed a quiet life to the extent that they were free from serious concern over cost-cutting and the saving of resources, and only had to avoid absolutely scandalous overspending.

These features contributed to a paradox: the economic system was dynamic, yet it was also conservative. It encouraged the growth of output, but not of efficiency. While output grew, radical structural and technological changes were inhibited; innovation was replaced by improvisation of the “make-do-and-mend” variety. When the strategic, technical, or cultural environment was changing rapidly, plans drawn up on the basis of existing structures tended to lag further and further behind reality. It was always easier to raise steel output by five per cent than to reorient the economy to meet new needs. The economy grew, but output grew only a little bit faster than inputs of capital and labour, so that there was little efficiency growth; by the 1980s the efficiency of resource use tended to decline.

## **A black hole**

Even before the present crisis inflationary pressure was the normal state of the Soviet economy; demand systematically exceeded supply, and the excess tended to rise from year to year. Underlying this was the behaviour of the Soviet public sector firm.

The Soviet firm's lack of efficiency motivation turned it into a black hole devouring resources.<sup>2</sup> Bonuses and medals were awarded for fulfilment of production quotas; penalties for incurring excessive costs while doing so were slight. Managers always strove to acquire additional machinery, materials, and workers, to enable them easily to meet government orders with as little effort as possible.

As for households relying on labour incomes, the workers were paid wages at the planned rate, but failed to work hard and supply consumer goods in planned quantities. Fuels and power, building materials, transport services, all kinds of goods which might have met consumer needs were syphoned off by firms and hoarded, or used in production, or diverted to the export market to pay for imported machinery. As a result, in most years the value of consumer goods and services officially supplied to the retail market fell short of consumer purchasing power. Since official prices did not rise, state shops saw queues, waiting lists, and rationing of high quality goods and services according to privilege. In addition, pent-up consumer demand spilled over into a free market where food was traded legally, and a black market where stolen and smuggled goods were also resold.

A last consequence of the old system was its tendency to disintegrate. Everyone – firms, farmers, households – inhabited a world in which supply was unreliable. You never knew when the next consignment of components would arrive (or how much of it would be usable), or when toothpaste or fresh fruit would next be on sale. Everyone grabbed what they could, when they could, regardless of the price, but would offer their own products or services grudgingly, only after striking a hard bargain. Best was to be self-reliant, independent of both market and official supply. Every family might aspire to its own vegetable allotment, every factory to its own foundry, power plant and toolroom. But this was at enormous cost to the economy in duplication of small-scale, high-cost facilities.

## The demand explosion

The transition from latent instability to imminent catastrophe was triggered in the Gorbachev years. The key factor was the relaxation of the CPSU political monopoly and the emergence of open political competition. A direct result was that demands on the economy grew fantastically, while at the same time the economy's supply side began to collapse.

The first consequence of political pluralism was to reinforce government commitments to state spending. The regime was already committed to a costly investment programme to modernise industry and raise living standards; Gorbachev's policy of "acceleration" added to this commitment. His government maintained its traditional guarantee to protect loss-making enterprises from closure by subsidising them from the budget; it soon incurred new obligations to

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<sup>2</sup> For many curious examples of Soviet "black holes" that swallow resources" see N. Shmelev and V. Popov, *The turning point: revitalizing the Soviet economy* (London, 1990), pp. 112-154.

increase the wages of striking fuel and power workers. Other budgetary obligations to social spending aimed to remedy years of neglect of health care, education, housing, and the environment, increase benefit payments to low income households, and maintain low food prices in state shops by means of food and farm subsidies. Lastly, despite the end of the Cold War, there were strong pressures to maintain defence spending, both to guarantee jobs and privileges in the military-industrial complex, and to protect the living standards of military personnel.

At the same time, budget revenues declined. Among the underlying causes were the decline of output (of which more below); as sales and incomes fell, less tax could be collected. Second, with growing national separatism, republican authorities from the Baltic region through the Ukraine and the Caucasus to Central Asia increasingly failed to pass on local taxes to Moscow.

Other factors also diminished budget revenues. Most taxes were traditionally based on taxing the public sector. In 1988-9 there was a huge increase in profit-related bonus payments to the workforce, sharply reducing profits taxation. The growth of the private sector also undermined the tax base. Private sector incomes rose as more and more people began to make a living from exploiting the failures of state supply, but the government lacked any means of capturing a share of this income for budget revenue. There was no PAYE outside the public sector; without an organised system of calculating liabilities and allowances, taxes were gathered only after negotiation, confrontation, and delay, often with arbitrary and unjust results. In 1985-8, an anti-alcohol campaign also lost significant tax revenues from vodka sales.

As a result, the Soviet budget deficit widened into a chasm; according to Grigorii Khanin, by 1991 it had reached one fifth of national income.<sup>3</sup> Moreover, this budget deficit was still more serious for the Soviet economy than for a western market economy. Unable to turn to a large, sophisticated money market, the Soviet government had no chance of raising the necessary deficit finance from domestic borrowing, and therefore had no alternative to printing the necessary roubles. Still worse, Soviet firms and households, once in possession of the new cash, were increasingly unwilling to save it, and had no alternative use for it than to turn it directly into new demand for goods and services which were increasingly short in supply.

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<sup>3</sup> "Syphoning" is a major concept of the school of shortage economics (e.g. J. Kornai, *The economics of shortage*, 2 vols (Amsterdam, 1980)) with important policy implications. Under conditions of retail shortage, some experts argued that freeing consumer prices and allowing them to rise would choke off excess demand. Probably, however, this was wrong. Raising consumer prices just meant transferring real income, and therefore purchasing power, from households to firms. The rate at which firms syphoned off goods from the retail market would have risen, maintaining the shortages at a still lower level of consumer supply.

For decades, Soviet households tolerated rising cash savings partly because of the low, stable prices of goods on sale in official shops; believing that one day these shops would supply sufficient quantities at the low official price, they were willing to accumulate substantial cash hoards. Meanwhile, they also needed large sums for free market and black market transactions. But by last year confidence in the long term value of accumulated roubles had been thoroughly eroded by government plans to raise prices, and by actual inflation. A transition was taking place towards the desire to hold wealth in non-cash forms such as cigarettes, gold, diamonds, furs, or in dollars. Once it began, the pressure of demand on the supply of such things became unbearable, rising inflation became a self-fulfilling expectation, and households faced growing pressure on all to release their remaining roubles and turn them quickly into physical wealth before they lost all value.

## The collapse of supply

Traditionally, two things held the Soviet economy together. One was force and the other was money, but of the two the most important was force. Force was required because of an inbuilt tendency for things to disintegrate. Firms and households, unwilling to depend on unreliable suppliers, struggled to achieve self-sufficiency. Under the old regime, this quest for self-sufficiency was limited by the centralised power of the party-state bureaucracy, which enforced supply deliveries on lower levels. With the Communist Party's political monopoly abolished, and its economic role sidelined, an unrestrained search for self-sufficiency ruled the supply side.

The inflationary process has also worked to undermine supply. Money helps to integrate large, complicated economic systems as long as, when paid in money, suppliers know what they are receiving in exchange. But when money is no longer trusted as a form of wealth, it also ceases to function as a means of exchange. Transactions become prohibitively expensive, and exchange comes to a halt. You're a farmer, growing beets – you need a tractor part. Now you must find a tractor factory which (a) has the part you need, and (b) needs beets. You're a car mechanic, in need of a winter coat. Now find a retail outlet which (a) has coats in stocks, and (b) needs a truck repair. You're a lecturer who needs bread. Now find a baker who (a) has bread in stock, and (b) wants to hear a lecture about the reign of Catherine the Great ... Some parts of the economy have limped along by using dollars, but here is no solution for dollars are very scarce, circulate only locally, and cannot cover the budget deficit. When the economic mechanism breaks down in this fundamental way, the only ones who can afford to go on living are the farmers, who are self-sufficient in food; in the long run, medieval conditions would return.

The most spectacular expression of the universal trend to self-sufficiency has been in trade wars. In market economies, trade wars are fought to share out demand. Countries try to grab foreign markets through "unfair" competition (e.g. dumping), or protect their home markets by restricting imports. In the disintegrating Soviet economy,

trade wars are the other way around – fought to share out supply, and by restricting exports. Russia denies electric power to the Baltic region, which denies its vegetables and meat to Russia. Russia denies its oil to the Ukraine; the Ukraine denies its wheat to Russia, and tries to keep Russian tourists out of Ukrainian shops. But these are just the headline events. On a smaller, more local scale everyone has been doing it. And the single most important aspect has been farmers' denial of food to the towns, accompanied by municipal authorities' exclusion of farmers from urban shops by issuing ration coupons only to urban dwellers. This is why Moscow is short of basic foods.

## What price recovery?

Hence the appeal for western food aid, despite the fact that Russia is not a low-income, resource-poor, low-technology country. In this desperate situation, aid is a palliative, offering a temporary increase in supply, and stabilisation of prices, for Russia's beleaguered urban consumers.

What lies beyond it? The measures undertaken since 1 January, 1992, are a start. Further sharp increases have taken the price of necessities beyond the reach of most working people's incomes – deliberately so, the aim being to force families to use up their hoarded cash savings and food stocks. But this is only the start. The danger is that, rather than being a corrective price increase, followed by stabilisation, it will become the first round of a true hyperinflationary spiral. And this can still happen, if the budget deficit is not corrected, and if loss-making public sector firms continue to syphon off resources without adding to supply.<sup>4</sup>

Under present plans the budget deficit will be slashed. Spending is being cut back, and new taxes collected. Price rises are intended to eliminate subsidies; eventually, much of the public sector may be closed down or sold off, and widespread redundancies may be expected where firms are privatised.

Savage budget cuts and economic restructuring will inevitably be associated with a further increase in already widespread suffering, economic injustice, and social polarisation. But only these measures can bring demand back under control and at the same time unlock the supply side from its downward spiral. This may appear unacceptable in a country with entrenched egalitarian norms and a newly powerful democratic movement. But the factors causing it have already been set in motion. It should not be used as an excuse for postponing action. What seems politically impossible must be done and, in fact, will be done, in Rudiger Dornbusch's words, "because the destruction brought

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<sup>4</sup> G I Khanin, "The Soviet economy: from crisis to catastrophe," Stockholm Institute of Soviet and East European Economics, Working Paper 33 (1991), pp 11-12.

about by uncontrolled inflation is so devastating that it forces cooperation.”<sup>5</sup>

El'tsyn has hardly any options. There is no longer any left-wing or right-wing alternative, or socialist, capitalist, or “third” way. TINA (There Is No Alternative) rules, not El'tsyn, and not his unruly, populist-minded deputy Rutskoi. The question is not what must be done, only by whom, and how soon. And the answers to these two questions will determine respectively the political and the social price still to be paid for correcting Russia's present economic troubles.

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<sup>5</sup> R. Dornbusch, “Experiences with extreme monetary instability,” in S Commander (ed), *Managing inflation in socialist economies in transition* (Washington, DC, 1991), pp 176-7.