

December 13, 1991

ECONOMIC SHOCK THERAPY: LESSONS FOR RUSSIA FROM EASTERN EUROPE

INTRODUCTION

Confirming a reality that had been apparent for months, last week the leaders of Russia, Ukraine, and Byelorussia proclaimed the dissolution of the Soviet Union and announced the establishment of a "Commonwealth of Independent States" to replace the Soviet Union. By effectively proclaiming the death of the Soviet center, this decision removes the last real obstacle to free market economic reform for the republics of what was the Soviet Union. It follows on the heels of a series of radical economic reform measures announced by Russia over the past six weeks.

Boris Yeltsin has demonstrated that he intends to transfer Russia decisively into a market economy. Yeltsin's measures include, or are about to include, freeing most prices and wages, privatizing state enterprises and agriculture, tightening the money supply by raising interest rates and cutting the government budget deficit to near zero, and, possibly, eventually introducing a new Russian currency of ruble notes imprinted with Russia's traditional colors, red, white and blue.

The price of Yeltsin's program will be some short-term economic dislocation and hardship. This is unavoidable. Sweeping reforms are needed if Russia is to reverse its economic free fall and begin the economic growth which will raise living standards.

Refuting Doomsayers. Already within Russia, and in the West, doomsayers warn that Yeltsin's plan will lead to ruin. This is refuted by the evidence accumulating in Eastern Europe where similar "shock therapy" plans have succeeded. The main problem so far with shock therapy is that it has failed to put enough emphasis on enacting quickly the reforms needed to promote the rapid development of the private sector, such as protecting private property rights, deregulation, and tax reform. This is the main lesson that Yeltsin and his group of young Russian economists can learn from Eastern Europe's experience with economic reform.

In Russia's effort to rebuild its economy, George Bush can help. He can encourage Yeltsin to remain undeterred by the critics. Bush also can propose that Yeltsin speed the development of the private sector by deregulating the economy, protecting property rights, and cutting taxes on Russia's entrepreneurs.

Deceiving Statistics. Russia is getting ready to introduce its economic shock therapy exactly two years after Poland became the first former East Bloc country to adopt sweeping economic reforms. From most official statistics and independent economic estimates, the experience in Poland and the rest of Eastern Europe seems discouraging: living standards falling anywhere from 20 percent to 50 percent, gross national product dropping between 10 percent and 20 percent, production down 15 percent to 30 percent and skyrocketing unemployment.¹ Similar statistics from Eastern Europe helped convince Soviet President Mikhail Gorbachev early last fall to abandon the "500-Day" radical economic reform plan proposed by a Russian economic team led by Stanislav Shatalin and Grigory Yavlinsky.

Such gloomy statistics are deceiving. They hide, for instance, the economic miracle sweeping Poland and Hungary. Thus while official statistics show declines in Polish production, these mostly measure only the output of state enterprises. In the budding private sector, by contrast, output is booming. Further distorting many widely reported statistics are the baselines used to determine growth or contraction. These baselines are still the overblown estimates of the size of East European economies before the 1989 revolutions. Example: the United States Central Intelligence Agency (CIA) estimated East Germany's 1987 per capita GNP at 88 percent of West Germany's; the real figure turns out to be less than 50 percent.

Alleged huge drops in living standards, meanwhile, fail to reckon the hard to quantify improvement in living standards from the disappearance of lines, the higher quality products, and most of the earnings from the growing private sector. Unemployment statistics also mislead. While under communism unemployment technically was "zero," in fact it simply was "hidden," with workers being paid for jobs that were not done. Today, however, Eastern European official unemployment figures overstate the scope of the problem. In Poland, for example, over 50 percent of those collecting unemployment earn outside income.

Real Hardships. There are, of course, hardships in switching from one form of economic system to another. On the road to a market economy, many state industries will go bankrupt, unemployment will increase temporarily, prices will rise (at times abruptly and sharply) to market levels, and many people will lose some real income as the state sector of the economy collapses. What will offset these pains will be the rapid growth of a private sector economy.

While some pain is certain, what is uncertain are the political consequences of the pain. Yeltsin thus runs a high political risk in pushing his economic reform program. To his credit, he has accepted full responsibility for its success or failure, assuming the post of Russian Prime Minister to see the reforms through himself. He must be aware that former Polish Prime Minister Tadeusz Mazowiecki was voted out of office a year after launching similar reforms.

Yeltsin will need all the help he can get from George Bush. Bush should recognize Yeltsin's courage, urge him to stay the course, and offer solid advice on how to make

¹ Various independent and government sources including the statistical offices in the East European countries, the World Bank, International Monetary Fund, and Plan Econ, a Washington-based consulting firm.

his reforms work by taking further steps to remove regulations now stifling the development of a strong market economy.

Specifically, Bush should recommend to Yeltsin that he:

- ◆ ◆ **Persevere with sweeping economic reforms.** If Yeltsin falters and fails to carry through with his announced reforms, chances are high that the Russian economy will continue to collapse. This would be an economic and political disaster, and court a return to authoritarian or totalitarian rule. This would be in neither Russia's nor America's interest. To guard against likely future harsh criticism of the reforms, Bush can help Yeltsin muster the evidence to debunk myths about the supposed failure of economic "shock therapy" in Eastern Europe. Official statistics that seem to show massively falling production, declining living standards and soaring unemployment in Eastern Europe misrepresent the true economic picture there. In fact, Eastern Europe is in the early stages of an economic renaissance.
- ◆ ◆ **Press forward with further reforms to spur the rapid development of Russia's private economic sector.** The key to offsetting the economic hardships imposed by a collapsing communist command economy is the rapid growth of a new private sector capable of creating jobs and boosting production. To spur the development of Russia's private sector economy, Yeltsin should undertake further reforms, including:

Reform # 1: Recognize and extend private property rights. Without a body of laws covering such basics as how to acquire and gain title to property, the risks of starting and expanding businesses in the Russia will remain high.

Reform # 2: Create a "regulation-buster" office to eliminate and cut through bureaucratic red tape. Countless regulations and bureaucratic impediments remain a significant obstacle to the growth of private business in Russia.

Reform #3: Make business licensing nearly automatic. Bribes to bureaucrats and a wait of up to one year for a business license discourage would-be businessmen.

Reform #4: Cut business taxes. High tax burdens on business discourage new business formation.

RUSSIAN ECONOMIC REFORM

Russia encompasses three-quarters of the area of the Soviet Union and accounts for 62 percent of Soviet output. Larger by a factor of ten than most of the economies of the other Soviet republics, Russia dominates in almost every category of production. It is endowed with plentiful natural resources such as oil, natural gas, and minerals.

This vast potential, however, has not prevented the inefficiencies of communist central planning from turning Russia into a pauper. Food shortages are predicted this winter in major cities, including Moscow and St. Petersburg. Inflation is running at 2 percent to 3 percent a week. National income in the Russian republic decreased by 5.5 percent last year and plunged another 11 percent in the first half of this year. Imports and exports are declining precipitously.²

Sporadic Reforms. Russia's economic problems start with an inefficient holdover communist economy that has been stagnating for years. Economic woes have been compounded by the absence of a coherent, decisive program for transforming this decaying economic system into a modern free market economy. Until very recently, reform proceeded halfheartedly and sporadically.

To be sure, some important measures were undertaken. Late last year Russia began laying the legal framework for a market economy when the Russian parliament began enacting important laws on private property, housing, land and industry privatization, foreign investment, and entrepreneurship. In early December 1990, the Russian parliament passed an historic land law that gives Russian farmers the right to obtain land from the Russian government and establishes private family farms; over 30,000 private farms have been created in Russia since January 1991.³

Another important reform aimed at increasing economic freedom for Russian citizens is the July 4, 1991, Law on Housing Privatization. Most Russians now have the chance to become owners, free of charge, of their own apartments by applying for a voucher that can be used to purchase the apartment. In St. Petersburg, the privatization of shops, restaurants, and industry began this April. The Moscow city government plans to turn all state-owned shops up to 500 square meters in size over to private owners within the next month. The workers of the shops will have first priority in ownership. The equipment will be given away free and the storefronts will be acquired through long-term leases.

Speeding the Transition. All of these reforms, as important as they are and as revolutionary they would have been a couple years ago, will amount to little as long as the Russian economy remains essentially a command economy, with prices fixed by the state, with a huge economic bureaucracy, and with countless restrictions on foreign investors. Yeltsin set about addressing these fundamental issues beginning with an October 28 address to the Russian Congress of People's Deputies. There he announced that his government will institute Polish-style economic "shock therapy" to speed the transition to a market economy.

Under his plan, on January 2, 1992, prices will be freed from administrative control on all but a few politically sensitive goods such as coal, gas, oil, baby food, bread, milk, salt, and vodka.⁴ Prices on many goods are expected to increase between two-fold and four-fold soon after prices are freed.⁵

2 Radio Free Europe/Radio Liberty *Daily Report*, No. 22, January 31, 1991, p. 6.

3 The Communists in the Russian legislature forced Yeltsin to place a ten-year moratorium on land sales. Yeltsin recently attempted to have this provision removed, but the Russian Congress of People's Deputies upheld the moratorium.

4 Radio Free Europe/Radio Liberty *Daily Report*, No. 209, November 4, 1991, p. 2.

Yeltsin also will slash the Russian government budget to bring the deficit to near zero. Freeing prices will go a long way toward this goal because subsidization of food-stuffs alone eats up much of the bloated budget. The number of bureaucrats employed by the Russian government will be reduced by 50 percent within months.

Agricultural privatization is being accelerated by privatizing the supply, retail, and distribution networks. In addition, the 1992 Russian budget also allocates over 24,000 tractors and 22,000 trucks to the emerging private farmers.

Attracting Foreign Investors. Over the weekend of November 16 and 17, Yeltsin unveiled a package of additional measures designed to free foreign trade from centralized control. In a series of executive decrees, Yeltsin eliminated most government exchange controls on imports, exports, and foreign currency. Fixed exchange rates set by Gosbank, the Soviet central bank, no longer apply in Russia. Enterprises are free to buy and sell hard currency at rates set by the free market. As of January 1, foreign businesses will be allowed to convert their ruble profits to hard currency on free currency markets, and take them back to their home country. Termed "repatriation," this will make Russia a much more favorable place for foreign investment.

Individual Russian citizens will be able to open hard-currency bank accounts. Soviet officials no longer will be permitted to tax imports or exports within Russia. These decrees, together with a November 15 announcement that Russia is taking over from the Soviet government control of its gold, oil, and other precious commodity reserves, will weaken the central government tremendously, leaving it without much ability to earn hard currency.⁶

In an effort to slow down the uncontrolled printing of rubles, and stave off hyperinflation and the economic and political chaos it would bring, on November 29, the Russian republic closed down Gosbank and took control of the money supply. Stabilizing the ruble will require massive budget cuts, higher interest rates, and pegging the currency to a Western hard currency such as the dollar or a basket of commodities. The Russian government also has taken over responsibility for financing the Soviet payroll and on December 1, Russia assumed control of the Soviet Ministry of Finance.

Political Support, Popular Opposition. Yeltsin now has broad political support in the Russian parliament for his sweeping economic reforms. Only seventeen deputies in the Russian parliament voted against the measure to grant him the power to carry out his reforms. The Russian people, however, are not as supportive as the deputies of radical economic reforms. Most polls show the majority are opposed to a rapid transformation to a market economy. Once the reforms are in place, opposition is sure to build as prices rise and official statistics begin to show ostensible further declines in wages and production. Communist Party members, for example, are sure to try to sabotage the reforms. Gorbachev already is positioning himself as a critic of reform, as demonstrated by his November 4 speech to the U.S.S.R. State Council when he said Yeltsin's reforms would hurt the poor. Such demagogic politicians as Vladimir Zhirinovskiy, who

5 Leyla Boulton and John Lloyd, "Russia Braced for Massive Price Increases," *Financial Times*, London, October 29, 1991, p. 1.

6 Fred Hiatt, "Yeltsin Asserts New Powers on Economy," *Washington Post*, November 18, 1991, p. A1.

received six million votes in the election for the Russian presidency, has said repeatedly that he will capitalize on economic pain to rally support for a return to authoritarian rule, a larger and stronger army, and the restoration of Russia's empire.

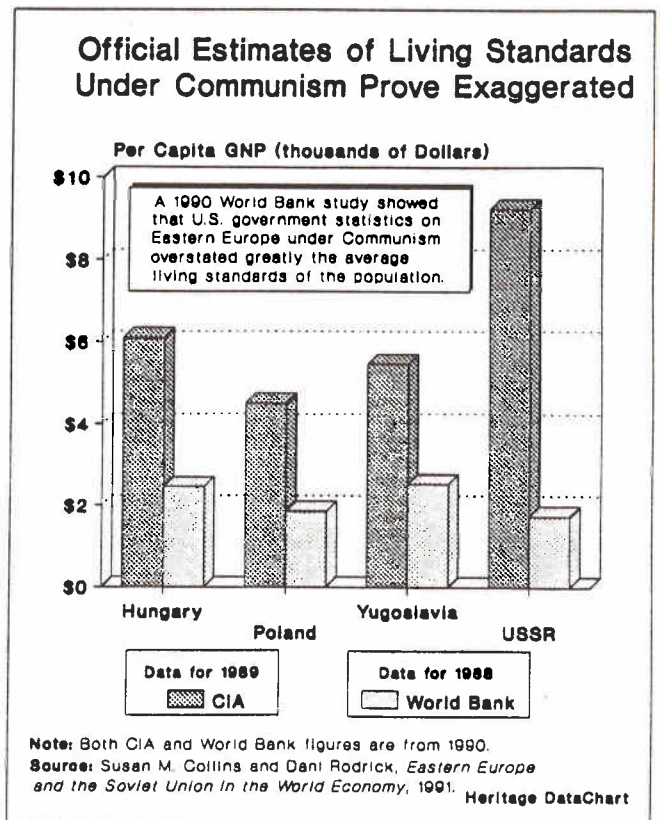
OFFICIAL STATISTICS HIDE THE TRUE STORY

One weapon that Yeltsin's critics invariably will use against him are the same kind of data that now portray Eastern Europe's sweeping economic reforms as a failure. Upon close analysis of the evidence however, it is clear that the horror stories about the impact of economic shock therapy in Eastern Europe are wildly misleading. These are based on statistics that show tremendous drops in production, national income, and living standards since market reforms were introduced, along with soaring unemployment and inflation.

In fact, these statistics reflect mainly the collapse of the inefficient state sector, which dominated the East European economies in the communist era. Not appearing in the official statistics is the good news that some of the worst evils of these economies are disappearing: poor services, hidden unemployment, shoddy consumer goods, and long lines for basic necessities.⁷ The statistics also largely ignore Eastern Europe's economic renaissance, as a new private sector begins to flourish.

Living Standards

Statistics on East European living standards compiled before the 1989 revolutions are now recognized as having been seriously flawed. These statistics painted a vastly exaggerated rosy picture of life under communism. Not measured by the statistics, of course, were the long food lines, poor quality products, massive shortages, empty shelves, and lack of purchasing power that people confronted daily. The real East European living standards were much lower than generally assumed. The CIA in 1989 estimated the per capita gross national product of Poland at \$5,450. The International Monetary Fund, however, now puts Poland's pre-reform per capita income at around \$1,100.



⁷ Peter Clark and Constantin Menges, Ph.D., "Economic Transition in Eastern Europe: A First Assessment," *Program on Transitions to Democracy*, June 31, 1991, p. 2.

Supposed huge declines in living standards are arrived at by looking only at declines in wages. Wages declined by 40 percent in 1990 in Poland after increasing by 28 percent between 1988 and 1989.

These numbers, however, had little to do with the actual living standards of Poles as measured by their purchasing power. In 1988 and 1989, Polish workers were given massive wage increases in an attempt by the government to appease labor unrest. The meaningless increases simply

were eaten up by rampant hyperinflation and shortages of most goods.

Since reforms were enacted in 1990, however, individual purchasing power in Poland in U.S. dollars, as measured by the black market exchange rate—which gives a far better picture of the actual value of currency than official exchange rates—is up. Example: in 1989, the average monthly wage of Poles was \$28 at the black market rate; it now is nearly \$150. Much of the presumed post-communist fall in East European living standards is pure illusion.

No More Panic Buying. With official statistics so unreliable, the quality of an individual's life is difficult to measure. But some improvements are clear enough. Today in most of Eastern Europe, foods and goods once nearly impossible to obtain are plentifully available at shops and market stalls. Gone is the panic buying that marked life under communism as households hoarded because of uncertainty over the future availability of basic goods. With prices now freed, and shortages virtually eliminated, panic buying and hoarding no longer are a part of everyday life. The disappearance of panic buying causes demand to fall in the short run, thus giving the appearance of a drop in living standards. In fact, the drop in demand due to the end of panicky economic activity reflects an improvement in everyday life.

Moreover, the high inflation in the late 1980s in Hungary and Poland caused people to spend virtually all their income on food and consumer goods rather than putting it into savings accounts where it simply would decline in value. With inflation much lower and interest rates higher, people are saving more of their income. Savings are four times higher in Hungary than two years ago, now equaling over 10 percent of earnings. This also shows up statistically as a drop in consumer demand, which looks bad on paper, but in fact it reflects the increasing confidence in the local currency, a sure sign of economic improvement.

Further refuting the claims that living standards have plummeted in Eastern Europe is the fact that actual household purchases have fallen only slightly. Evidence: According to official statistics, food sales in Poland declined between 30 percent and 40 percent in the first half of 1990 compared to 1989. Surveys of individual households, however, demonstrate that household consumption dropped at most only by about 5 per-

Official Statistics Mask Real Increase of Wages in Poland			
Year	Monthly Wages		
	Current Zloty	Real Zloty	Dollars
1987	30,722	917	na
1988	50,661	969	\$32.68
1989	130,454	1,304	\$28.24
1990	946,822	822	\$98.38
1991	1,713,300	945	\$149.48

Note: Polish currency (zloty) wage data from June of each year. Real zloty values are adjusted for inflation. Dollar values represent earnings at prevailing black market exchange rate.
Source: Zloty wage data from Polish Central Statistical Office, *Monthly Statistical Bulletin*, various issues. Exchange rate data from the *International Financial Statistics* from the International Monetary Fund, 1991.

Heritage InfoChart

cent during the same period.⁸ Further, even this relatively small drop fails to measure the great increases in the quality and quantity of food and other goods available.

Production and GNP

Statistics concerning declines in production in Eastern Europe follow a similarly misleading pattern. Official government statistics document one-third declines in industrial production and gross national product (GNP), supposedly offering further proof of a decline in human welfare.⁹ Again, conventional wisdom simply is wrong.

Under communism in Eastern Europe, managers were paid and rewarded for the production figures they reported to the planning ministry, not for what was actually sold on the market. Production figures were highly inflated by factory managers trying to fill their production quotas. Termed *prispiski* in Russian, such cheating took place in over one-third of all enterprises in the Soviet Union.¹⁰ Also distorting measures of GNP in the communist countries was that output was only measured in quantity, not quality. These practices and others led to overestimates of at least 25 percent in estimates of gross national product in Eastern Europe.¹¹

As prices have been freed, subsidies cut, and real interest rates introduced, the performance of managers and the very existence of their enterprises is determined by what is sold on the market, rather than what is reported to ministry officials. As a result, the phony output numbers simply disappear from statistics, thus leading to the horror stories of one-third drops in production. While there have been large production drops in the state sector, they are considerably lower than usually reported.¹²

Business Hoarding. Another factor contributing to the apparent drop in production is the reduction in huge stocks of inventories traditionally maintained by communist enterprises. These enterprises typically have ordered excess supplies and have kept huge stocks of inventories on hand because of uncertainty about whether the supplies would be available when needed. With free prices and the introduction of market forces, supply networks are becoming more reliable. The result: hoarding of supplies drops. With the forces of competition, at work, moreover, enterprises no longer can afford the extra costs of excessive inventories. As a result, demand for inputs falls, which corresponds to a statistical drop in production. Again, this statistical decline simply is indicative of an economy that on the whole is becoming more efficient.

8 Andrew Berg and Jeffrey Sachs, "Structural Adjustment and International Trade in Eastern Europe: the Case of Poland," preliminary paper prepared for the Economic Policy Panel in Prague, October 17-19, WIDER. Their analysis is based on a number of Polish government surveys including, *"Informacja o Wybranych Elementach Warunkow Zycia Ludnosci w 1990 R."*, Polish Government Survey, GUS, Warsaw, Poland, April 1991.

9 Gross National Product (GNP) is the sum of all economic transactions in a country including trade.

10 Jan Winiecki, "The Inevitability of a Fall in Output in the Early Stages of Transition to the Market: Theoretical Underpinnings," *SOVIET STUDIES*, University of Glasgow, Vol. 43, No. 4 (1991), p. 670.

11 Charles Wolf Jr., "Eastern Europe Can Avoid a Crash," *Wall Street Journal Europe*, November 21, 1990.

12 Berg and Sachs, *op. cit.*, estimate that GNP in Poland declined by at most 6.5 percent in 1990.

Unemployment

Much has been made of a reported unemployment crisis as Eastern Europe moves toward a market economy. Here again it is the statistics that are misleading. Ostensibly, unemployment has risen from zero to nearly 5 percent in Hungary and from 3 percent to 10 percent in Poland.

Officially all countries of the former Eastern Bloc reported zero unemployment under communism. The zero unemployment figure was achieved by giving everyone a job, no matter how menial, and putting people on the state payroll whether work was done or not. The official statistic of zero unemployment thus hid gross overemployment in factories and elsewhere, resulting in wasteful duplication of effort, and wages paid for work not done. Unemployment existed, but was "hidden" or "repressed." When former communist countries institute market reforms, this hidden unemployment is exposed.

Officially unemployment in Hungary rose from 1.7 percent in 1990 to 4.6 percent by this July and is expected to reach 9 percent next year. The number of registered unemployed Hungarians has gone from 85,514 in 1990 to between 300,000 and 320,000 this year. These numbers show only part of the picture.

Supplementing Income. Otilia Solt, head of the lobby on poverty in the Hungarian parliament, estimates that eight out of every ten individuals registered as "unemployed" have other sources of income. Polish officials contend that about half of the registered unemployed in Poland have other sources of income. "Unemployed" Poles include private entrepreneurs trying to augment their incomes or housewives supplementing the family income with unemployment benefits. Many of the registered unemployed have jobs in the "gray" or informal sector of the economy where their work escapes government detection and taxation.

Many workers in state enterprises, meanwhile, are voluntarily leaving the state sector for the much higher wages and greater opportunities in the growing private sector. Demand for skilled labor is very strong in most sectors, accounting for almost zero unemployment in many of Poland's largest cities.¹³

Dynamic Private Sector Growth

The main reason that official statistics about East European economies are misleading is that they scarcely begin to take account of the tremendous increase in private sector activity this year and last. Most private sector activity simply goes unreported because the government still lacks the administrative capability to measure it. Many businesses, moreover, do not register to avoid heavy taxes. Much of the economic value added to East European economies by the hundreds of thousands of new private companies will take a few years to be fully realized, while enterprise failures in the state sector show up immediately.

Rapid Private Sector Growth. According to the latest private figures for Poland, over 1.15 million new private small businesses and 30,000 private companies have

13 "Poland: Facing a Dual Economy as Elections Approach," Deutsche Bank Economics Department, *Focus Eastern Europe*, Deutsche Bank, Washington, D.C., p. 121.

been created since market reforms were introduced. As in the U.S., many of these new businesses and companies have failed, but many also have succeeded.¹⁴ According to these figures, the private sector added 26 percent more to the Polish economy in 1990 than in 1989.¹⁵ Private sector retail sales more than quadrupled last year, representing over 40 percent of total retail trade. In early 1989, less than 10 percent of all retail stores were in the private sector. Now around 85 percent of all retail outlets are privately owned. Private sector industrial output also is way up; increasing by 8 percent in 1990.¹⁶ The private sector now accounts for about 20 percent of total industrial sales in Poland.¹⁷

What thus is happening in Eastern Europe is not the wholesale collapse of national economies, but the destruction of the inefficient state sector and the parallel rapid growth of the private sector.

This new sector is the driving force behind economic expansion. Most of Hungary's 40 percent growth in trade with the West this year has been driven by newly created small- and medium-sized private Hungarian companies. In Romania, new private businesses exported over \$168 million in goods in the first half of this year. The race is on to see if the private sector can grow quickly enough to absorb the workers, production, and services from the falling state sector.

FORGING A PATH TO GROWTH

Russia today finds itself at an economic crossroads. Voices within Russia—former communists, some populists and authoritarians—and even in the West will be begging Yeltsin to turn back, warning him that the road of sweeping reform is potholed with danger and will lead to economic ruin. In choosing to press ahead, Yeltsin shows tremendous personal courage. He also demonstrates a deep understanding that this is Russia's chance, perhaps its only chance for decades, to make a complete break with its failed command economy and to move toward a Western-style free market and the growth and prosperity that it can bring to his country.

It is in America's interest as much as Russia's that Yeltsin succeed. A free market and democratic Russia is America's best guarantee that the Cold War and its dangers will never return. For America's sake and for Russia's, George Bush actively should encourage Yeltsin's reforms and advise him on further measures he should take to ensure the rapid growth of a private sector economy.

14 *Poland: International Economic Report 1990/1991*, World Economy Research Institute, Warsaw School of Economics, 1991, p. 64.

15 Jeffrey Sachs, "Accelerating Privatization in Eastern Europe," paper prepared for the World Bank's *Annual Conference on Development Economics*, Washington, D.C., April 1991, p. 3.

16 Paul Hare and Irene Grosfield, "Privatization in Hungary, Poland and Czechoslovakia," Centre for Economic Policy Research, *Discussion Paper Series*, No. 544, p. 12.

17 Deutsche Bank, *op. cit.*, p. 1.

Bush should encourage Yeltsin to:

◆ ◆ **Persevere with sweeping economic reforms.**

Yeltsin's sweeping reforms, due to take effect on January 1, 1992, are essential to dismantling Russia's failed command economy and creating the conditions for a new, free market economy to grow. These reforms inevitably will impose a degree of economic pain as inefficient state enterprises begin to fail, leading to falling production and rising unemployment.

Right now, however, Russia is in the midst of a severe economic decline, with no hope of arresting it in sight. If the Russian government fails to act decisively, as the Soviet government has failed to do over the past few years, the decline will continue and accelerate. As it is, the economic uncertainty is keeping foreign investors from investing in Russia. The ruble is virtually worthless, forcing many economic transactions to be conducted by barter. The country is on the brink of hyperinflation. Yeltsin's economic reforms will not solve these problems immediately, but unlike the present course of inaction, they offer tremendous hope for turning around the Russian economy in coming months and years. Bush can help Yeltsin move in this direction by providing him with the economic facts he needs to debunk myths about the putative failure of economic "shock therapy" in Eastern Europe. Against the chorus of doomsayers spouting horror stories about economic shock therapy in Eastern Europe, Yeltsin must offer the facts. Gloomy official statistics hide Eastern Europe's economic renaissance. On the ruins of Eastern Europe's crumbling state sector, a thriving private sector is growing, creating jobs, products, and services for domestic consumption and export.

Alleged drops in living standards fail to account for the disappearance of lines, introduction of higher quality products, and most of the earnings from the growing private sector. Unemployment statistics also mislead. Under communism, unemployment was hidden, with workers being paid for jobs that were not done; today unemployment is real, but jobs are being created rapidly in the fast expanding private sector. Moreover, official East European unemployment figures overstate the scope of the problem; in Poland, over 50 percent of those collecting unemployment earn outside income.

◆ ◆ **Press forward with further reforms to spur the rapid development of the private economic sector.**

In Russia, as in Eastern Europe today, sweeping reforms will doom many giant state enterprises that form the backbone of these economies, even if state enterprises become private companies. This will cause some hardships. But the main lesson of economic shock therapy in Eastern Europe is that the key to offsetting these hardships are reforms that spur growth in the private sector. With the state sector in decline, only a growing private sector can offer displaced workers jobs, extra income to state factory workers, job opportunities to college graduates, higher quality consumer goods, and world-class information, communication, and distribution services to help attract foreign companies and their capital.

Such reforms to trigger private sector growth will have to be a top priority for Yeltsin and Yegor Gaidar, his new economics minister. If they fail to push these new measures, shock therapy simply may shock the old command economy into collapsing more quickly than the new market economy can grow. This would be a disaster.

Among the new reforms needed to rapidly build a private sector in Russia are:

Reform # 1: Recognize and extend private property rights.

When a government restricts access to property, it removes a primary incentive for the creation of new businesses or improvement of existing businesses. People have little incentive to improve their land or invest in new machinery unless they have guarantees that their property will not be arbitrarily confiscated by the state.¹⁸ Unlike the ineffectual Soviet parliament, the Russian parliament has proclaimed the inviolability of property rights.

This is an important first step. But this also does not secure property rights. To do this, an entire set of rules and institutions to facilitate property arrangements must be developed quickly. These include: a titling system that makes ownership of property unambiguous; adoption of legal mechanisms for transferring property; contract law that allows parties maximum leeway, secure in the knowledge that contract terms will be enforced by the courts; tort law to protect property from trespass and nuisance; commercial codes that contain real rules governing the sale of goods and property; and the establishment of systems of collateral, that protect debtors and creditors.¹⁹ Such basic legal rules, which allow businesses and individuals to interact predictably, are needed if new businesses are to be created and thrive.

Reform # 2: Form a "regulation-buster" office to eliminate and cut through bureaucratic red tape.

If the private sector is to grow in Russia, the government immediately must remove burdensome government regulations that hinder the creation and profitability of private business activity. A simple rule should be adopted: everything not expressly forbidden should be permitted.

To enforce this rule against the entrenched communist holdover bureaucracy, a high-powered deregulation office with powers to push aside bureaucratic opposition is needed. These "regulation busters" would have the power unilaterally to eliminate bureaucratic and regulatory impediments to private enterprise creation, like burdensome permit and paperwork requirements and arbitrary government restrictions and regulations on private sector employment, wages, hours, sick leave, vacation, and output. The deregulation office would be the chief advocate of private enterprise in the government and could keep Russian businessmen and entrepreneurs informed of their new rights.

18 Edward Hudgins, "Private Property: the Basis of Economic Reform in Less Developed Countries," Heritage Foundation *Background*, No. 770, May 24, 1990.

19 For a summary of some of the obstacles facing private businesses in post-socialist countries, see "Poland: Small Business Project: Outline of Recommendations," GEMINI and IRIS report prepared for the U.S. Agency for International Development (AID), Washington, D.C., March 15, 1991.

Reform #3: Make business licensing nearly automatic.

Despite the good intentions of such Russian laws as the Law on Enterprises and Entrepreneurship, adopted in December 1990, business licensing in Russia remains a lengthy process and thus a formidable barrier to private enterprise. It now takes most Russian entrepreneurs at least two months to fill out the forms and obtain the necessary signatures to start a business; in most of America, by contrast, it takes a matter of hours. It is common for businessmen to wait for up to a year for a license in the Soviet Union. It should be no surprise, therefore, that bribing officials to obtain licenses is an accepted part of the system. Business licenses should be granted automatically unless within fourteen days the government denies the request for a legitimate reason. In most cases, obtaining a business license should take no more than one day.

Reform #4: Cut business taxes.

Businesses in Russia are taxed at a rate up to 35 percent under a complicated business tax system which taxes different types of companies differently. High and complicated taxes on business discourage new business development. The Russian government could remove most tax barriers by replacing corporate profits taxes with a simple, low, flat business tax with no deductions or exemptions, except for money invested back into the business.

Russian tax laws, moreover, unwisely favor joint ventures with foreign corporations over domestic entrepreneurs. Such joint ventures are granted either lower tax rates or a two-year tax holiday from the government. This creates an incentive for Russian entrepreneurs to seek out foreign partners to avoid taxes, even if the partner has no real role in the venture. The Russian government should put Russians and foreigners on equal footing, preferably by granting Russian firms the same incentives as foreign firms for starting new businesses, or by eliminating the incentives for foreigners.

CONCLUSION

Boris Yeltsin has made a courageous decision in following the lead of such East European countries as Poland in adopting sweeping economic reforms. Yeltsin also has taken a risk. In coming months, opposition to his reforms will mount as short-term economic hardships are felt. Communists, authoritarians, and populists will play on fears of change, and accuse the Russian government of imposing severe hardship on the Russian people.

Already, Yeltsin's critics are pointing to dire official statistics that appear to show a sharp drop in production and living standards and a precipitous rise in unemployment where radical free market reforms have been undertaken in Eastern Europe. In fact these statistics mask an economic rebirth that rapidly is propelling Eastern Europe toward a new prosperity.

Help for Yeltsin. In answering his critics, Yeltsin will need help. George Bush can help him. Bush can start by treating Yeltsin with the respect heretofore reserved for the more timid Mikhail Gorbachev. Bush should back Yeltsin's economic reform plan publicly, and urge him to stay the course. He further can help Yeltsin by arming him with the facts about economic reform in Eastern Europe, which belie the gloomy picture painted by official statistics. These statistics do not capture the tremendous increases in production in a booming private sector, nor do they document the tremendous increases in the quality of life for East Europeans, including the end of shortages, disappearance of long lines at shops, availability of varied and high quality goods, better services, and technological advance.

Bush also has a role to play in advising Yeltsin on the future course of reform. Measures already announced by Yeltsin undoubtedly will cause some short-term economic problems. These only can be offset by a growing and dynamic private sector. Bush should advise Yeltsin to undertake additional reforms to dismantle quickly obstacles to private enterprise. These include the expansion of property rights, establishment of a "regulation-buster" office to eliminate and cut through red tape, streamlining the process of issuing business licenses, and cutting business taxes.

Russia's fate rests on the success or failure of Yeltsin's economic reforms. If Yeltsin succeeds, he has a decent chance to lead Russia toward democracy, free markets, and certain prosperity. If he fails, Russia might return to authoritarianism and perhaps expansionism. It is in America's interest as well as Russia's that he succeed.

William D. Eggers
Policy Analyst

Heritage intern Todd Leeuwenburgh, a graduate student in the Elliot School of International Affairs, at George Washington University assisted in the preparation of this study.

All Heritage Foundation papers are now available electronically to subscribers of the "NEXIS" on-line data retrieval service. The Heritage Foundation's Reports (HFRPTS) can be found in the OMNI, CURRNT, NWLTRS, and GVT group files of the NEXIS library and in the GOVT and OMNI group files of the GOVNS library.