The Failure of Market Reforms in Russia: Competing Paradigms of Information Economics and Neoclassical Economics

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This manuscript is the second of two papers exploring the transition from centrally planned to market-based economies. The first paper published in the previous issue of the Journal of Applied Business investigated the new information paradigm applied in China. The current paper focuses on the failures of the "Washington Consensus" paradigm based on the old neoclassical paradigm and applied in Russia. As in the previous manuscript, this study supports the argument that markets cannot be efficient without government regulation, intervention, social institutions and effective public administration.

RUSSIAN FAILURE

The collapse of the Soviet Union ended the Cold War. Although it has become politically incorrect to say so, one cannot deny that the West won. One of the reasons for this victory was the naive miscalculation of Mikhail Gorbachev. As Deng Xiaoping mentioned in 1990, "Gorbachev looks intelligent, but is in fact naïve. If he lost his control of the Party, how could he control the country?" (Zhang, 2000, p. 193).

The communist party played a central role in the public administration and economic system of the Soviet Union. In his article "Changes in Soviet Economic Policy-Making in 1989 and 1990," Anders Aslund also surprisingly came to the same conclusion about Gorbachev as Deng Xiaoping did:

> *Incredible as it may sound, Gorbachev had annihilated the central policy-making system without constructing any viable alternative, at the same time as the economic crisis was moving towards its peak. . . . He had not only failed to develop but also seemed disinterested in developing well-functioning democratic and confederative structures. Single-mindedly, he concentrated on reinforcing the presidency, while confusing everyone and avoiding any vital decisions. His previous restructuring of policy-making institutions seemed to have become mere destruction. A broad popular opinion had long realized that the government was not capable of forming a viable economic policy (1992, pp. 112, 115, 116).*

Gorbachev truly believed his New Thinking would be rewarded with a "Marshall Plan" for the Soviet Union involving billions of dollars in grants. According to the former Soviet intelligence chief Vladimir Kryuchkov, "Gorbachev was persuaded by Western promises and staked on broader involvement and participation of the West in resolving Russia's economic and domestic political problems. Gorbachev sincerely believed that the West will help us with advice and money, be it 100, 200 or even 300 billion dollars, and that is why, as Gorbachev thought, there was no point in trying to analyze our economic policy blunders" (*Tribuna*, June 14, 2000). However, the hundreds of billions of dollars expected to flow from the West after the end of the political *perestroika* never materialized. In explaining why he was unable to choose among dozens of often similar programs for the transition to a market economy, Gorbachev blamed the West:

> *By 1989–90 a sufficiently broad consensus emerged in support of a socially oriented market economy. In Houston in the summer of 1990, my message to the G7 (Group of Seven) laid out this conception and expressed the determination of the Soviet leadership to put it into practice. The strategy of step-by-step movement to the market was subjected to sharp criticism. The West called for a "more decisive" approach. . . . their suggestions as to the tempo and methods of transition were astonishing (Klein & Pomer, 2001, p. xiv).*

Why were those advocating the Washington Consensus so persistent about pursuing a strategy of "shock therapy"? Policy-wise, they decided that it was better to adopt a large package of radical measures while society was in a state of disarray and interest groups could not yet fully assess whether they were to benefit or to lose. Additionally, the majority of the population was ready to endure hardship for a time, but not for long (Aslund, 1995). From the perspective of economic theory, neoclassical economists also prescribed "shock therapy" and "big bang" strategies; in contrast, information economists advocated flexibility in the speed of reform, including incrementalism (or gradualism) and staging (Stiglitz, 1994).

The Russian reformers had to begin their efforts in the context of a severe economic and institutional crisis. However, Boris Yeltsin went even further in the direction of institutional destruction than Gorbachev. The Washington Consensus of the U.S. Treasury Department and the International Monetary Fund (IMF) shaped Russia's "big bang" economic course toward a market economy. The package included "shock therapy" price liberalization, budgetary austerity, the rapid privatization of state enterprises, and other assets, immediate exposure of the country's unprepared producers to foreign competition, and a minimal role for the government. The Russian "dream team" of young economist reformers led by Yegor Gaidar and Anatoly Chubais gave their total support to "the proven answers of economic theory and practice" (Hough, 2001, p. 1). It was a revolutionary time of market romanticism and fundamentalism. This period, which was highly beneficial to a few but devastating to the majority, revealed the first Russian president's naivety. On October 28, 1991, Yeltsin declared to the Russian people:

> *A one-time changeover to market prices is a difficult and forced measure, but a necessary one. For approximately six month things will be worse for everyone, but then prices will fall, the consumer market will be filled with goods, and by the autumn of 1992 there will be economic stabilization and a gradual improvement in people's lives (Nelson & Kuzes, 1995, p. 3).*

Many academics, including Goldman, suggested that the "one-time changeover to market prices" was a serious mistake. In January 1992, Gaidar abolished state price controls over all but a few products. At this time, most of Russia's industry, agriculture, and services were still monopolistic and state-owned; supply was highly inelastic. Moreover, output diminished when prices rose. "The drop in production was not just due to cutbacks in the military industrial complex; the production of consumer goods also fell sharply. Within three years' time, output had fallen by 50 percent in many sectors. All of this happened while prices rose 26 fold in 1992 and tenfold in 1993" (Goldman, 1996, pp. 264-265).

The next great crisis in August 1998 introduced novel facts that were completely inexplicable from the perspective of supporters of the Washington Consensus and neoclassical economics in general: continued decline in output, high inflation, the fall of the ruble, a lack of fiscal revenues, the proliferation of organized crime, generalized asset diversion, and capital flight.

Republican U.S. Representative Christopher Cox's report entitled "Russia's Road to Corruption: How the Clinton Administration Exported Government Instead of Free Enterprise and Failed the Russian

People" represented one of the most comprehensive criticisms of the radical reforms in Russia in the 1990s (Cox, 2000). In March 2000, Speaker of the House Dennis Hastert charged the leadership of six committees of the House of Representatives, headed by Congressman Cox, with the task of assessing the results of U.S. policy toward Russia during the Yeltsin years. The resulting report was published in September 2000. The Democratic Caucus accused the authors of taking a partisan approach.

However, we believe that neither political party could be held responsible for the dominant paradigm in economics at that time. America's involvement in Russian affairs had already begun during the George H.W. Bush administration. Steven Cohen notes that the idea of "doing their thinking for them" had reemerged in the American mainstream in 1992, the first post-Soviet year and the last year of the first Bush administration:

> *In April, for instance, a special gathering of government, business, media, and academic representatives recommended that the United States and its allies "deeply and swiftly engage themselves in the process of transforming the political and economic orders of the former Soviet republics." . . . But it was the Clinton administration that turned the missionary impulse into an official crusade – though, it should be emphasized, with enthusiastic Republican Party support in Congress (2001, p. 8).*

As Cohen wrote, "even prior to the Clinton administration American missionaries had already assigned to the IMF a primary organizational role in the crusade as the 'only one in the world that has a relatively clear view of how Russia can most effectively reform its economy'" (2001, pp. 9, 280).

Later, in the aftermath of the East Asian financial crisis, the Washington Consensus was increasingly under attack. Stiglitz criticized the IMF's conditions for bailing out East Asia, which imposed stringent stabilization measures, inducing a severe recession. He called for a "post-Washington Consensus" (Stiglitz, 1998). "Perhaps unfortunately for the countries in transition, the East Asian crisis and along with it the reconsideration of standard stabilization policies came too late to offer an alternative policy mix," wrote Marie Lavigne (1999, p. 161). However, the "post-Washington Consensus" touted by Stiglitz was nothing more than the application of ideas from the information paradigm to the problems of transition and development. China had applied this approach several years earlier, starting in December 1980.

Stiglitz offered an analysis of Russian failures from the perspective of economic theory in his keynote address to the World Bank Annual Bank Conference on Development Economics, Washington, D.C., April 28-30, 1999. The address was entitled "Whither Reform? Ten Years of the Transition." Stiglitz contrasted the miserable Russian experience in the 1990s with "the enormous success of China, which created its own path of transition (rather than just using a 'blueprint' or 'recipe' from western advisors)" (1999, p. 3).

Unless we declare Stiglitz to be an Eastern economist, these remarks seem disingenuous.

Many of the ideas in "Whither Reform?" were based on Stiglitz's presentations to Chinese and East European audiences in December 1980 and April 1990, respectively. Well known for his advocacy of transparency in national and international public administration, Stiglitz had to be opaque about his role in the success of Chinese transition and development. To prove the superiority of the new paradigm over the old one not just on the theoretical level, but also in real-world application, he must have strongly wanted to cite the success of China. However, he was limited to outlining only the failure of the old paradigm applied to the Russian transition. Perhaps in his effort to make the Russian "failure case" more convincing, Stiglitz unjustly separated the Soviet and post-Soviet periods of Russian history. This viewpoint made him an easy target for criticism by the supporters of radical reforms during the Yeltsin period. Unlike Stiglitz, we believe that all the credit for the poor Russian performance during the "transition" period should not be given to Yeltsin and his "dream team" of economist-reformers. Without Gorbachev's prior missteps, they would never have failed so badly.

Time and practice have proven the validity of Stiglitz's ideas and refuted the hypotheses and recommendations of the competing traditional paradigm. For instance, hopes that privatization would lead to restructuring by the market have been widely dashed:

One fundamental error (similar to one which we have encountered in the past couple years in East Asia) is a failure to distinguish between what is required in the case of restructuring a single firm within a well-functioning economy, and restructuring virtually an entire economy, or at least the manufacturing sector of an economy (Stiglitz, 1999, p. 15).

It is difficult to disagree that the issue should not be depreciated by seeing it only as intellectual questions of overlooking new insights from information economics, misunderstanding the foundations of a market economy, and blind reliance on reform models based on traditional neoclassical economics:

One deeper origin of what became known as the "shock therapy" approach to transition was moral fervor and triumphalism left over from the Cold War. Some economic cold-warriors seemed to have seen themselves on a mission to level the "evil" institutions of communism and to socially engineer in their place (using the right textbooks this time) the new, clean, and pure "textbook institutions" of a private property market economy. From this cold-war perspective, those who showed any sympathy to transitional forms that have evolved out of the communist past and still bore traces of that evolution must themselves be guilty of "communist sympathies." Only a blitzkrieg approach during the "window of opportunity" provided by the "fog of transition" would get the changes made before the population had a chance to organize to protect its previous vested interests (Stiglitz, 1999, pp. 2, 22, 23).

Chubais acknowledged in an interview given years after the transition that the destruction of communism was the main goal of his reforms (Chubais, 2010). His opinion that it was better to privatize the economy, even in the hands of criminals, rather than to allow "red directors" to stay in management is supported by the neoclassical paradigm, but not by information economics. According to the informationists, "the distribution of initial wealth has effects on the nature and the incentive problems facing society" and you cannot separate "the issue of efficiency from distribution" (Stiglitz, 1994, 2012).

Many Russians and some outsiders think that the persistent help of the neoclassical crusaders was intended primarily to use the "free market" to destroy the military and economic potential of the Soviet Union and Russia, rather than to aid their development. The issue is not really relevant in the context of this article. What is important here is that the recommendations of neoclassical economics made the Soviet Union/Russia "one of the most spectacular" and "stylized" case studies of failure in transition economics (Roland, 2000, p. xviii).

THE CONTEST OF PARADIGMS

The transition from socialism to capitalism or, more precisely, from centrally planned to market economies, affected the lives of approximately 1.65 billion people in 30 countries. It was one of the most important economic events of the twentieth century, along with the socialist experiment and the Great Depression. The varied experiences of the countries going through the process of transition provides a rich opportunity for researchers to both understand the process of reforms and to gain insights into economics and the workings of economies. The economies of the other post-socialist countries were dwarfed by those of the Soviet Union/Russia and China. The movement of these two enormous economies back to the market in the end of the last century provided a "crucial experiment" (Kuhn, 2012; Lakatos, 1970) for dogmatic Marxist economics; however, it was a much more captivating experiment pitting traditional neoclassical economics against the new information economics.

From an academic perspective, when comparing the results of economic policies derived from the two different and competing paradigms, one should remember that economic "shock therapy" in Russia was not implemented consistently. Off-budget subsidies to state enterprises were often a factor. However, the main question is whether government intervention destroyed an excellent economic program that would otherwise have been successful or whether government intervention was a desperate attempt to ward off a disaster that the economic program itself would have produced.

Jerry Hough addresses these questions by examining the ways in which the incentives established by the economic program actually functioned. The conclusion does not favor the old paradigm: "The pure neoliberal model would not be tolerated anywhere, certainly not in the United States, and real market incentive structures vary with time and place" (Hough, 2001, p. 13).

Roland wanted to "make research on transition better known and recognized in the academic community by showing that the policy issues of transition … have raised new questions for economics and generated serious and innovative research that is relevant beyond transition itself" (Roland, 2000, p. xxvii). However, he did not even mention the most relevant work on the problem – *Whither Socialism?* Rather than contrasting the old neoclassical paradigm, the "Washington Consensus" and the "big bang" strategy in Russia with the information paradigm and the *post*-Washington Consensus, Roland turned his attention to the "evolutionary-institutionalist perspective" in transition economics; this perspective was proposed and developed only after the transitions had begun. It was largely based on inductive thinking and case studies. It was not difficult to criticize the recommendations of neoclassical economics *after* China succeeded and the Soviet Union/Russia failed using the very different strategies chosen by their leaders. Stiglitz had commented on the "evolutionary approach" in general a few years earlier:

> *Of course, if evolutionary forces "naturally" led to desirable outcomes (whatever that might mean), then the economist's task would be a simple one: to observe and comment on the process. But as economists, we are called upon to analyze a variety of proposed changes in policies and institutions. As our tools of analysis have improved, we are in a better position to ask of any proposed change, what are its effects? In evolutionary terms we can ask, is it likely to survive? We are even in a position of engaging in social engineering, of asking, can we design institutions or policy reforms that are likely to be welfare improving, or, again in evolutionary terms, that are likely to have survival value? (1994, p. 277).*

The "crucial experiment" comparing the experiences of the Soviet Union/Russia against those of China has visibly demonstrated that the information paradigm and new information economics were more successful than the traditional economic paradigm and neoclassical economics in terms of empirical applications, theoretical explanations, and predictions. The resulting change in the worldview of many economists was so profound that the break with the past was defined as an intellectual revolution (Stiglitz, 2000, 2003, 2004) or "revolution in, or more exactly, around economics" (Fine, 2001).

We believe that this "paradigm shift" in economics represents a historical and logical process of building a new paradigm that preserves, when possible, the links with the old economic orthodoxy. After all, Stiglitz (1994) remarked, building a new paradigm is a slow process. The information revolution in economics was not an instantaneous discovery or one attributable to a single economist; instead, it was a lengthy process involving the collective work of dozens of bright economists from the economic mainstream with the helpful influence of their colleagues and competitors from other economic schools. There are many former neoclassicists, now "informationists," who have developed new models, theories, and taxonomies for discovering novel facts, rediscovering old ones, and for building a new central core of economics. George Akerlof, Michael Spence, and Joseph Stiglitz shared the 2001 Nobel Prize in Economics "for their analyses of markets with asymmetric information". Important contributions to the information paradigm have also been made by Richard Arnott, Partha Dasgupta, Bruce Greenwald, Sanford Grossman, Barry Nalebuff, David Newberry, Roy Radner, Steven Salop, and Andrew Weiss. Still, Stiglitz has played the leading and integrating role in this process of "extraordinary science" (Kuhn, 2012).

Historically and logically, the standard competitive paradigm represents a simpler, narrower, and more restrictive version of the new information economic paradigm. The new information paradigm is broader; in Karl Popper's words, it is a "better and roomier theoretical framework" that relaxes many fundamental assumptions associated with traditional economic thinking (Popper, 1970, p. 56).

However, unlike Stiglitz, we believe that the revocation of the old universal economic laws and fundamental theorems (supply and demand, single price, price equals marginal cost, and the "invisible hand" theorem) and reformulation of basic conceptual definitions (market equilibrium and price-quality dependency) is only a denial of their historical (for all times) and logical (in all contingencies) generality; this revocation does not imply that traditional neoclassical economics is unscientific or mythical. The situation in modern economics strikingly resembles Kuhn's (2012) eloquently expressed and well-known example of the Newton-Einstein theoretical contraposition in physics.

The new information economics has placed the problems of optimization at the center of economic analysis in terms not only of quantity but also quality. Quality may influence price but, although it may seem initially paradoxical, price may also define quality. This "perceptual switch" in our fundamental economic view of the quality/price causality – from quality-price to price-quality – matches perfectly with Kuhn's description of changes in worldview using the famous duck-rabbit optical illusion[1]. This 180-degree turn of the economic *gestalt* made possible the greatest intellectual revolution in economic science.

The information paradigm represents progress and growth of knowledge in economics. In its practical applications, the information paradigm has been much more successful than the old standard paradigm. The information paradigm, beyond a wealth of specific results, has changed the way we think about the modern economy and economics.

Stiglitz was awarded a Nobel Prize in 2001. Since 1969, Nobel prizes for economics have been awarded to one to three people every year. However, it is not every century that a theoretical 'hard core' (according to Imre Lakatos) or a 'fundamental paradigm' (according to Thomas Kuhn) of economics is replaced. Being a witness to the information academic revolution is a true delight to those who appreciate economics and its history. In the major critical experiment of two competing economic paradigms, "history" chose China over the Soviet Union/Russia. Time and practice proved the supremacy of a new, information paradigm in economics. The traditional paradigm of neo-classicism and monetarism and the ensuing Washington Consensus have failed to withstand the competition.

CONCLUSION

Must human history repeat itself? In the times of a worldwide financial crisis and Great Depression, John Keynes wrote:

> *The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas (1936, p. 383).*

Certainly, the power of special interests can have implications for how fast these new ideas spread. Furthermore, as a new behavioral school of economics has demonstrated, an explanation of that "frenzy" can also be found in the natural human irrationality, particularly in regard to money. Is there a light for the "men in authority" and a hope for us?

The failed Russian transition, otherwise known as the Russian revolution of 1986-1999, has already ended (Starodubskaia and Mau, 2004). However, there is still time to prevent the second global great depression and its likely tragic consequences. Public administration should provide us with the tools and knowledge to avoid ineffective reforms. These considerations have prompted us to present the recent major progress in economics for practitioners and scholars of national and international public administration.

Furthermore, Donald Kettl noted in his article "The future of public administration" that "some of the most interesting recent ideas in public administration have come from outside the field" (Kettl, 1999, p.128). We believe that the new information economics can be a powerful intellectual source of such ideas. Economics has always played an important role in the American public administration. "The impact of economic schools and theories…is both massive and subtle. For better or worse, the criteria of action in public administration are intimately entwined with the enterprise of economics" (Waldo, 1980,

p. 175). Fortunately for the discipline of public administration, the current intellectual environment within economics has become far better than what Dwight Waldo had to endure. "Muddling through" (Lindblom, 1959) is not the only option anymore. The new information economics built a highway over the economics muddle by profoundly challenging the fundamental free-market, libertarian premises underpinning neoclassical economics and the old economic paradigm. Public administration, government regulation and intervention, and social institutions do matter for the markets to be efficient.

It is our hope that this paper can start a discussion among public administration scholars and practitioners about the possible impact of the new information economics on the further development of national, international – and in the future, conceivably global - public administration.

ENDNOTE

1. Is this a duck-rabbit  …or a rabbit-duck?

   Retrieved from http://illuzi.ru/node/594 Accessed 07.12.2018.

ACKNOWLEDGEMENT

We are grateful to Anna Amirkhanyan, Gwendolyn Stewart, Stuart Thorson, the editor, and the reviewers for their helpful comments on earlier versions of this paper.

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