Rethinking the State and the Economy: Lessons from the Collapse of State Socialism

Amado Mendoza, Jr.

Robert Inman reminds us that as markets are imperfect, so too are states. The most apparent flaw in *realsozialismus* was the attempt to replace the market with the state. In doing so, civil society was likewise 'replaced' by the state with all its disastrous consequences.

Markets cannot replace states; in the same manner, states cannot replace markets. As institutions, markets and states perform distinct functions. Markets, *qua* markets, can best direct and stimulate economic activity by way of price formation. No state, even with the best computer technology, can match the market's capability to set prices right. If prices were 'wrong,' one can have the absurd situation where consumer demand is unmet while unwanted goods pile up unsold in warehouses.

In the Soviet Union, the statist economy produced competitive (meaning world class) quality only when the state itself was the costumer. For instance, the Soviet Mig-31s, AK-47s, Golf-class SSBNs, and MIRVed ICBMs were all at par with the weapon systems that the US could deploy. Only in the crisis-gripped 1980s was the Soviet system unable to produce an answer to Reagan's Star Wars System.

The same result will be true for homogeneous products such as electricity, water, and other utilities. Indents for such goods from all over the Soviet Union could still be handled well because these orders from below will only differ in terms of quantity.

However, the Soviet system was unable to manage the production of such heterogeneous goods as ball bearings, shoes, among others. The central price-setting and planning agency cannot deal with the deluge of information coming from below. For that matter, indents for running shoes, work boots, loafers will all get consolidated at the center as footwear. So farming villages will receive slinky high heels while athletic camps may be swamped with steel-toed work boots.

Soviet managers faced a 'soft budget constraint' that discouraged economy and abetted wasteful duplication and hoarding of production inputs. The perverse reward-punishment system, which rewarded over-production in an overly lucrative manner (and punished slightly below-target performance severely), also encouraged firm directors to behave in this manner. Such a system, while able to propel peasant Russia into the industrial age, was unable to meet the requirements of a more sophisticated age.

Notwithstanding the Soviet experience, the knee-jerk reaction of replacing the state with the market is likewise not indicated here. As Noel de Dios had aptly observed, even as orthodox theory extols markets to the high heavens, it has yet to teach us how markets are created, where virtually none existed (or where poor imitations exist).

We need to reinterpret classical liberal economic doctrine. The labors of the Smithian 'minimalist state' created the dynamic free markets of capitalist Europe. The state of Smith was not a minimalist one in the sense of being puny. How can a state expected to maintain or enforce order and secure a nation's defense; administer justice and ensure fulfillment of obligations and enforcement of contracts; and provide other public goods such as roads and ports to facilitate commercial transactions be ever considered a weak state?

The contraposition between state and market is, therefore, a false one. In situations where free and competitive markets do not exist, states must create them. An inequitable market does not even itself out; giving free rein to market forces and disallowing state intervention will only perpetuate the prevailing unevenness and disparities in market power.

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Furthermore, free markets do not stay very competitive in the long run. The logic of competition stipulates that some actors will win and others will lose. The obvious reward for the victors is a larger market share. Even without barriers to entry, latecomers obviously face substantial handicaps. Must the state now come in to even up the odds? But would not the large firms complain of being penalized for their market success?

A way out is seemingly provided for by participating in a larger market, e.g., the regional or global market. Given a larger market scale with more players, an oligopolistic supplier (in a national context) will be reduced to the proverbial "small fry in the big pond." But the same problem may be encountered if the larger industrial structure is itself not very competitive.

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The case of Yeltsin's Russia is instructive. Prices were freed from state control but the industrial monopolies were left intact. Financial discipline was not imposed. Rents were captured by these monopolies even as prices were freed. The windfall generated by price decontrol was, likewise, shared by the speculators, gangsters, as well as legitimate entrepreneurs simply because they operated as 'monopolists.' The case for market reforms was harmed in this manner during Gorbachev's time; a repeat during Yeltsin's first two years stymied the reform process.

In conclusion, moving away from the state towards the market is a tangle of political and technical questions. What seems to be purely technical must be appreciated in the light of its political repercussions. On the other hand, what seems to be politically acceptable should be examined for its soundness. Failure to do so can only freeze a post-statist economy in a crazy half-way house where prices are freely set, yet monopolists can restrict supply of goods and continue 'earning' monopoly rents.

As it is, freeing prices is the easier thing to do. However, markets need more to work their full magic. States may have better records in remedying these situations than markets. Or at least, state action is decisive at the initial stage of free market formation. The Russian state must, therefore, not shy away from its historic possibilities. These observations, however, are valid only if Yeltsin's project is indeed drawn along these directions. After all, one does not need a free market to stay in power.