

BOFIT
Discussion Papers
2004 ■ No. 15

Steven Rosefielde

An abnormal country



Bank of Finland
BOFIT – Institute for Economies in Transition

BOFIT personnel 2004

Economists

Mr Pekka Sutela, head

Russian economy and economic policy
Russia's international economic relations
China in the world economy
Pekka.Sutela@bof.fi

Mr Gang Ji, economist

Chinese economy and economic policy
Gang.Ji@bof.fi

Ms Tuuli Koivu, economist

Chinese economy and economic policy
Editor-in-Chief of BOFIT China Review
Tuuli.Koivu@bof.fi

Mr Tuomas Komulainen, economist

Russian financial system
Currency crises
Editor-in-Chief of BOFIT Online

Mr Iikka Korhonen, economist

Exchange rate policies in transition economies
Monetary policy in transition economies
Editor-in-Chief of BOFIT Discussion Papers
Iikka.Korhonen@bof.fi

Mr Vesa Korhonen, economist

Russia's international economic relations
Russia's banking system
Vesa.Korhonen@bof.fi

Ms Seija Lainela, economist

Russian economy and economic policy
Editor-in-Chief of BOFIT Russia Review
Seija.Lainela@bof.fi

Mr Jouko Rautava, economist

Russian economy and economic policy
Jouko.Rautava@bof.fi

Ms Laura Solanko, economist

Russian regional issues
Public economics
Laura.Solanko@bof.fi

Ms Merja Tekoniemi, economist

Russian economy and economic policy
Merja.Tekoniemi@bof.fi

Information Services

Mr Timo Harell, editor

Press monitoring
Editor-in-Chief of BOFIT Weekly
Timo.Harell@bof.fi

Ms Liisa Mannila, department secretary

Department coordinator
Publications traffic
Liisa.Mannila@bof.fi

Ms Päivi Määttä, information specialist

Institute's library
Information services
Paivi.Maatta@bof.fi

Ms Tiina Saajasto, information specialist

Statistical analysis
Statistical data bases
Internet sites
Tiina.Saajasto@bof.fi

Ms Liisa Sipola, information specialist

Information retrieval
Institute's library and publications
Liisa.Sipola@bof.fi

Contact us

Bank of Finland
BOFIT – Institute for Economies in Transition
PO Box 160
FIN-00101 Helsinki

Phone: +358 9 183 2268
Fax: +358 9 183 2294
E-mail: bofit@bof.fi
Internet: www.bof.fi/bofit



Steven Rosefelde

An abnormal country

BOFIT Discussion Papers
Editor-in-Chief Iikka Korhonen

BOFIT Discussion Papers 15/2004
1.9.2004

Steven Rosefielde
An abnormal country

ISBN 951-686-974-2 (print)
ISSN 1456-4564 (print)

ISBN 051-686-975-0 (online)
ISSN 1456-5889 (online)

Multiprint Oy
Helsinki 2004

Contents

Abstract.....	5
Tiivistelmä.....	6
An abnormal country	7
References	19

All opinions expressed are those of the authors and do not necessarily reflect the views of the Bank of Finland.

Steven Rosefielde

An abnormal country

Abstract

Andrei Shleifer and Daniel Treisman recently rendered a summary verdict on the post-Soviet Russian transition experience finding that the Federation had become a normal country with the west's assistance, and predicting that it would liberalize and develop further like other successful nations of its type. This essay demonstrates that they are mistaken. It shows factually, and on the norms elaborated by Pareto, Arrow and Bergson that Russia is an abnormal political economy unlikely to democratize, westernize or embrace free enterprise any time soon.

JEL Classifications: P30, P40, P51, P52

Keywords: Russia, transition, welfare

Steven Rosefelde

An abnormal country

Tiivistelmä

Andrei Shleifer ja Daniel Treisman arvioivat hiljattain Venäjän siirtymistä markkinatalouteen. Heidän mukaansa Venäjän federaatiosta on tullut länsimaiden avun avulla normaali maa. He ennustavat, että Venäjän taloutta vapautetaan edelleen ja se kehittyy kuten muutkin sen tyyppiset menestyneet maat. Tämän esseen tarkoituksena on osoittaa, että he ovat väärässä. Tutkimuksessa osoittautuu itse asiassa, että Pareton, Arrowin ja Bergsonin kriteereillä Venäjä on hyvin epänormaali maa, joka ei todennäköisesti demokratisoidu, länsimaistu ja toteuta vapaan markkinatalouden mallia lähitulevaisuudessa.

Asiasanat: Venäjä, siirtymätalous, hyvinvointi

An abnormal country

Voltaire, Candide, Chapter 1 - How Candide Was Brought Up in a Magnificent Castle and How He Was Driven Thence, 1759. (google, Online Literature Library).

"Master Pangloss taught the metaphysico-theologo-cosmologicology. He could prove to admiration that there is no effect without a cause, and that in this best of all possible worlds, the Baron's castle was the most magnificent of all castles, and my lady the best of all baronesses. 'It is demonstrable,' said he, 'things cannot be otherwise than as they are, for as all things have been created for some end, they must necessarily be created for the best end. They who assert that everything is right, do not express themselves correctly, they should say that everything is best.'"

Andrei Shleifer and Daniel Treisman have tried to rewrite history with metaphysico-theologo-cosmologicology (Shleifer and Treisman, 2004), a stale, determinist gambit. They have peered into Russia's soul and discovered that thanks to the G-7's advice, Yeltsin and Putin have done most things right. After more than a thousand years of repeated failure Russia has finally become a "normal country," humbug worthy of Pangloss,¹ but still shy of perfection. Perhaps next time, they will assure us that since everything is right in Russia, everything is best!

At a time when serious scholars and analysts agree that Russia's feeble democratization has misfired (Tenet, 2004); when the state has reasserted control over the media, and the security services (especially the FSB) have become the dominant force in the government,² Shleifer and Treisman tell us that Russia has "changed from a dictatorship to a multiparty democracy in which officials are chosen in regular elections."

¹ Shlapentokh also connects Shleifer's and Treisman's analysis with Pangloss. See Vladimir Shlapentokh, "Shleifer and Treisman's Economic Comparisons are Wrong," *Johnson's Russia List*, No. 8091, Article 16, February 28, 2004. Lawrence Summers and Stanley Fisher expressed views similar to Shleifer and Treisman at the American Economics Association meetings, January 4, 2003. John Odling-Smee, former Director of the IMF's European II Department 1992-2003 shares the same outlook. Also see Stanley Fischer and Ratna Sahay, (2004).

² Cf. Arkady Ostrovsky, "Is Russian Democracy Becoming an Illusion," *Financial Times*, reprinted in *Johnson's Russia List*, No.8042, Article 13, February 2004. Donald Rayfield reminds us that Russia "is ruled by a man who is, by career and choice, a successor to Yagoda and Beria," and today's FSB "has taken, in alliance with bandits and extortioners, the commanding heights of the country's government and economic riches, and goes on lying to, and when expedient murdering, its citizens." See, Simon Montefiore, book review of *Stalin and His Hangmen: an Authoritative Portrait of a Tyrant and Those Who Served Him*, Viking, 2004, reprinted in *Johnson's Russia List*, No.8114, Article 6, March 13,2004. Cf. Montefiore, "Democratic Despot," *New York Times*, (Op-Ed),March 14, 2004: "Vladimir Putin, who will be handily re-

When there is increasing awareness that Russian troops intend to occupy the Transdnistria indefinitely, re-establish hegemony in the CIS, and are ramping up for a major military modernization drive (Rosefielde, 2005), they remind us that "Its army has withdrawn peacefully from both eastern Europe and the other former Soviet republics (where Russia heads CIS military forces), allowing the latter to become independent countries."

When Russia is assiduously developing new ballistic missiles to outmaneuver America's national missile defense (NMD),³ and maintains 40,000 retargetable nuclear weapons (more with the simple reinsertion of nuclear triggers), they discover "a partner ready to cooperate on disarmament, fighting terrorism, and containing civil wars."

When Russia still finds itself mired in hyper-depression (GDP officially acknowledged to be approximately 25 percent below 1989⁴ having sustained 3.4 million excess deaths 1990-1998 (Rosefielde, 2001), and unemployment in the vicinity of 25 percent during the nineties (Rosefielde, 2000),⁵ with a vast "virtual" economy serving a tiny coterie of oligarchs and kleptocrats, they enthuse that Russia's "centrally planned economy has been reshaped into a capitalist order based on markets and private property," regaling us with the howler "Although economic output fell initially after the Soviet Union

elected president of Russia today, is never going to become a Western-style, liberal-democratic politician, no matter how much we wish it. He is a quintessentially Russian leader, with very traditional aspirations and interests, and until the West gets used to it, he will continue to be a tantalizing source of frustration and disappointment." "A reforming liberal leader in Russia is the Holy Grail of Kremlinology, but the search for one is as misguided and hopeless as that for the relic of the Last Supper. Believe it or not, some Western analysts in the 1930's insisted that Stalin was a 'moderate,' controlled by extremists like the secret police chief Nikolai Yezhov. Khrushchev became the next great hope after he denounced Stalin and ended the Terror in the 50's, but his real interests were personal power, state consolidation and Marxist Leninism. Mikhail Gorbachev was a reformer, but not a liberal - his real wish was to reform, not end, Marxism-Leninism." Also, Russia's pro-western orientation is shakier than Shleifer and Treisman acknowledge. In a recent story in the communist newspaper Pravda, it is easily observed that old attitudes persist. "Recently big anti-Russian campaign has been launched by European and American media depicting Russia as the new empire of evil where 'the state is terrorizing citizens, human rights are violated, businessmen are prosecuted and there is atmosphere of total fear to authorities.'" Their intention is to discredit Putin. This preamble, is followed with Soviet era invective, and the assertion that Russia is exceptionist, and superior to the west. Citing Alexander Sobyenin, the article suggests that conflict between the Russia and the west is inevitable because Russians are virtuous collectivists, while westerners are depraved egomaniacs. See Mikhail Chernov, "West Against Russia," *Johnson's Russia List*, No.8114, Article 6, March 13, 2004.

³ "New Russian Missiles to Outwit US Defenses," *Krasnaya Zvezda*, February 25, 2004, reprinted in *Johnson's Russia List*, No.8093, March 1, 2004. Russian forces will have the new missile, which will act like a swarm of bees against America's umbrella defense system by 2010.

⁴ *Economic Survey of Europe*, United Nations, No. 1, 2003.

⁵ Steven Rosefielde, (2000). At the end of 2003 8.6 percent of Russia's economically active population (6.2 million people) were unemployed. The labor force was 65.2 million. But adjustment for discouraged workers puts the figure in the teens.

collapsed, plausible estimates suggest that the decline had been reversed by 2003." No data show this; not Goskomstat's, nor any international organization's. Plausibility, it seems is whatever Shleifer and Treisman assert.⁶

Taking all these triumphs collectively into consideration, and forgetting that most western specialists considered the Soviet Union normal after 1953, they opine, "Russia's re-invention would seem cause for celebration," because it has become a normal country,⁷ just as Shleifer, the World Bank, IMF and EBRD persistently maintained since 1995,⁸ the

⁶ Shleifer and Treisman use 1991 as their benchmark, disregarding the 7.8 percent decline 1989-1991, when Russia's hyper-depression began. GDP 1991-2003 fell 19 percent on this measure. For comparison, American GDP plummeted 27.5 during the Great Depression 1929-33. Imagine, the reception Roosevelt's aides would have received had they claimed that America fully recovered by 1936, and they could prove it with their "plausible" estimates. See *Economic Survey of Europe*, United Nations, No.1, 2003, and recent official updates. This isn't the first time that those involved in the G-7's Russia assistance programs sought to deny the seriousness of the Federation's hyper-depression. See Maasaki Kuboniwa, and Evgeny Gavrilentov, (1997). Also, Goskomstat and the World Bank jointly revised Soviet GNP upward by approximately 10 percent in 1995 with implausible assumptions and gross arithmetic errors. When Rosefielde corrected the arithmetic, and notified the World Bank the errors were left uncorrected. See Rossiskaia Federatsiia: Doklad o natsional'nykh schetakh, (1995).

⁷ Anders Aslund, "Russia Gets on Track to Be a Normal Country," *International Herald Tribune*, March 19, 1997, p.8. Cf. Matthew Maly, (2002, 2004). Vladimir Shlapentokh contends that he was the first to use the term "normal country," citing his "'Normal' Russia" *Current History*, No.212, October 1997, "Contemporary Russia: The Best Parallel to It – Feudal Europe," *Europe-Asia Studies*, Spring 1996, and "Bonjour Stagnation: Russia's Next Years," *Europe-Asia Studies*, Vol.49, No.5, 1997. See Vladimir Shlapentokh, "Shleifer and Treisman's Economic Comparisons are Wrong," *Johnson's Russia List*, No.8091, Article 16, February 28, 2004

⁸ From 1992 to 1997 Shleifer headed the (now defunct) Harvard Institute for International Development project to reform the Russian economy. Shleifer (together with on-site Moscow director Jonathan Hay) managed virtually the entire U.S. economic aid portfolio for Russia -more than 350 million dollars - in addition to the 40 million dollars it received directly. The portfolio encompassed privatization, legal reform, capital markets, and the development of a Russian securities and exchange commission. Shleifer was more than just an adviser. He and Hay, wrote decrees for President Boris Yeltsin's signature and participated in some of the highest-level privatization decisions. They were intimately involved in the design and implementation of the voucher privatization program(USAID spent 58 million dollars to underwrite their activities, as well as for promotion of the program.) See Janine Wedel, *Collision and Collusion: The Strange Case of Western Aid to Eastern Europe*, New York, NY: Palgrave, 2001, Chapter 4; updated information provided by Janine Wedel, March 9, 2004. In 1996, the U.S. General accounting Office (GAO), the governmental body that monitors how appropriated monies are spent, found that Harvard had "substantial control of the U.S. assistance program." See U.S. General Accounting Office, Foreign Assistance: Harvard Institute for International Development's Work in Russia and the Ukraine, Washington, D.C.:GAO, November 1996, p.3. (Shleifer, Hay, and Harvard also allegedly defrauded an American mutual funds firm working in Russia. After publicly denying the allegations, Harvard quietly settled that case out of court.) The suit registered by Forum Financial Group of Portland, Maine, states that Hay and Shleifer used their pull with Russian officials to acquire for the company the rights to the country's first mutual fund. They then compelled its owner to sell his interest to the fund. When Forum filed suit in fall 2000, Harvard spokesmen Joe Wrinn called its claims "baseless." Yet, two years later, Harvard and its two co-defendants quietly settled with the company, denying any wrongdoing by it or the co-defendants. See, for example, David H. Gellis, "Harvard in Settlement Talks with Forum," *Harvard Crimson*, October 30, 2002; and "Harvard Settles with Mutual Funds Company Over Fraud Allegations," Associated Press, November 8, 2002. Information provided by Janine Wedel, March 9, 2004. Blasi, Krumova, Kruse, and Shleifer, (1997). Cf. Blanchard, Boyko, Dabrowski, Dornbusch, Layard and Shleifer,(1993). Shleifer and Vishny, (2000); Shleifer and Treisman, (2000); Boone, Gomulka and Layard(eds.), (1998). Also see Steven Rosefielde and Natalia

year Anders Aslund first revealed to the world that Russia had become a capitalist market economy (Aslund, 1995). The message is a thread barer rehash of Washington consensus advocacy circa 1997,⁹ thinly disguised to sensationalize their claim by insisting that realists have been shouted down by socialists and neo-conservatives.

Shleifer and Treisman then proceed to substantiate their hypothesis with official economic statistics, much the way the CIA did during the cold war when it failed to foresee the Soviet Union's impending demise.¹⁰ Although the CIA covered its tracks far more deftly than Shleifer and Treisman (Rosefielde, 2003, 2004, 2005), the technique is the same: adjust statistics to taste, and then make improper comparisons to show that the behavior implied proves "normalcy." Their assertion that Russian GDP has recovered to the 1991 level illustrates the first technique, and comparisons with Argentina (1991) and Mexico (1999) exemplify the later. We are expected to accept that "normal" Argentina and Mexico provide sound benchmarks for gauging the "normalcy" of Russia because both are "middle-income countries" with GDP per capita around 8,000 dollars (at purchasing power parity), neglecting to mention that former Goskomstat Deputy Director Aleksei Ponomarenko's estimate is closer to 5,000 dollars, and the CIA's figure in current prices exceeds 20,000 dollars.¹¹ Purchasing power parity estimates are sensitive to assumptions, and fluctuate with the political wind. Much of the slack depends on the valuation of the quality of Russian services, and non-exportable Soviet era goods for domestic use. When the Soviet Union, or Russia is made to look good, this is opaquely accomplished by assuming that rust belt goods, and inferior services are world class. Pangloss would have appreciated the jest. Soviet era goods and services produced in today's "virtual economy," as Clifford Gaddy and Barry Ickes portray it (Gaddy and Ickes, 2002),¹² are anything but

Vennikova, (2004). On June 29, 2004, Shleifer was found guilty on two counts of fraud, and may face a jury trial on another issue. See "Harvard Professor, Employee Liable in Fraud case, But \$102 Million Claim Against University Fails," *Boston Globe*, June 29, 2004 reprinted in Johnson's Russia List, No. 8274, Article 8, June 29, 2004. Shleifer and Hay were found to have violated the False Claim Act, and could face damages up to 102 million each.

⁹ The Washington consensus refers narrowly to macroeconomic policies which stress financial discipline, and broadly to the advocacy of democratic free enterprise. John Williamson, (1989, 1993, 2002). Williamson (1989).

¹⁰ The CIA and many Sovietologists are still in denial. See Berkowitz, Berliner, Gregory, Linz and Millar, (1993). Noel Firth, and James Noren, (1998).

¹¹ Steven Rosefielde, (1998), Table 1, pp. Xxii-xxiii. CIA, (1992), Tables 7 and 21, pp.25, and 39. The CIA's estimate for 1989 Russian per capita GDP in 1991 dollars was 15,631. Ponomarenko's figure for 1995 when production was 22 percent below 2003 was 3,750 dollars.

¹² The term "virtual" refers to old Soviet physical production relations underlying the visible market economy, and applies to most of the industrial, agricultural, and public service sectors. It has another

world class, to say nothing of the 23 percent of Russian GDP for which Ponomarenko and academician Valery Makarov acknowledge Goskomstat has no data. They are non-comparable precisely because the Russian system is abnormal, but as Pangloss says if what is, is right; what is right is best, and what is best is world class, then of course Russian performance is comparable to Argentina's and Mexico's, and all three are "normally" as good as any "normal" "capitalist" economy. This judgment we are relieved to learn holds, even though Shleifer and Treisman admit that "democracies in this income range are rough around the edges: their governments suffer from corruption, their judiciaries are politicized and their press is almost never entirely free. They have high income inequality, concentrated corporate ownership, and turbulent macroeconomic performance. In all these regards, Russia is normal. Not only are Russia's normalities normal, but its abnormalities are normal too!"¹³

Shleifer and Treisman concede that Soviet era goods were shoddy. They couldn't deny it, and still support their claim for a capitalist miracle. But in sharp contrast to Gaddy and Ickes, they contend that yesterday's worst goods have already been transmuted into today's best, even though investment in these sectors has been negligible. This enables them to argue, as they did in the early nineties, that Goskomstat exaggerated Russia's hyper-depression because the guns and shoddy goods lost were worthless; despite the Kremlin's status as the world's second largest arms exporter. Indeed, some of their fellow Panglossians contended that the value added of Soviet goods was actually value subtracted,¹⁴ so the steeper the decline the better the outcome.

It is also claimed that Russia's hyper-depression has been exaggerated by over-reporting during the communist period, and under-reporting thereafter without any serious effort at quantification. Are Shleifer and Treisman really contending that the Genshtab

important resonance, suggesting that official statistics provide an unrealistically rosy impression of Russian economic performance.

¹³ Matthew Maly noting the same nonsense says that Shleifer and Treisman define "normal" as "whatever you should be to satisfy my expectations." See Matthew Maly, "My comment on A Normal Country by Andrei Shleifer and Daniel Treisman," *Johnson's Russia List*, No.8081, Article 17, February 23, 2004. Cf. Ed Dolan, "Normal or Not," *Johnson's Russia List*, No.8087, Article 5, February 25, 2004. Shlapentokh calls Russia "normal," but uses the term to mean that Russian society, as it was shaped in 1991-1994, is able to function and reproduce itself for an indefinite period. See Vladimir Shlapentokh, "Shleifer and Treisman's Economic Comparisons are Wrong," *Johnson's Russia List*, No.891, Article 16, February 28, 2004.

¹⁴ Value added is the contribution primary factors of production make to raw materials. The claim that value has been subtracted means that processing diminishes the worth of raw materials. During Soviet rule this sometimes happened, but the incidence was small. For a brief time in the nineties it became fashionable to conflate true value subtracted with differences in tastes. Soviet systems directors wanted and got goods with characteristics westerners disesteemed, but this didn't mean that processing reduced the Kremlin's utility.

(Soviet General Staff) tolerated these abuses in the military industrial complex (VPK)? It would be amusing to see them try to prove it. Since Vitaly Shlykov (former deputy chairman of the Russian Security Council), and academician Yuri Yaremenko (who audited the numbers for the Politburo) put defense spending at 30 percent of GDP in the late eighties, fraud in the military sector matters. Nor do they acknowledge that Roskomstat made allowances for some of these alleged biases. They neglect to factor in the "second economy" production omitted from Soviet production, showcase electricity consumption as a reliable proxy for economic activity, even though they should know it isn't because industrial users paid virtually nothing for electricity during much of the nineties.¹⁵ The other rules of thumb cited suffer from the same deficiencies, and Shleifer and Treisman fail to seriously consider substitution and index number relativity issues associated with price decontrol. They do not adduce a shred of evidence that hasn't been previously discredited. Also, novices should note that Soviet statistics were never consistent, or reliable, and always exaggerated the performance of the consumption sector. With Russia suffering from mass involuntary unemployment throughout the nineties, with only token official acknowledgment, it seems reasonable to infer that reports of the good life are drastically overdrawn.

The next strawman scorched by Shleifer and Treisman is their critics' explanation of Russia's hyper-depression. Blame they declare doesn't lie with the "loans for shares" scandal, and derivatively with Shleifer himself for counseling "don't ask, don't tell" privatization,¹⁶ nor with haste (shock versus gradualism),¹⁷ because the irrelevant electricity index shows the fall began before 1994. And, if they are somehow mistaken; if the plundering of state property did play a role, then they find virtue in necessity, insisting that kleptocratic privatization was constructive because the brunt of the contraction was borne by weapons and Soviet era consumer "bads."¹⁸ Hyper-depression moreover they declare is a myth. The post-Soviet decline in aggregate production was merely a "recession," defined

¹⁵ Academician Valery Makarov, Director of the Central Economics and Mathematics Institute noted a decade ago that electricity is a small input into industrial production, and cannot serve as a reliable proxy for economic activity.

¹⁶ "Tainted Transactions: An Exchange," (Spring 2000), and replies by Jeffrey Sachs, Anders Aslund, Marek Dabrowski, Peter Reddaway, Igor Aristov, Wayne Merry, Michael Hudson, David Ellerman and Steven Rosefielde, "Tainted Transactions: Replies," (Summer 2000). Also, see Wedel, (1998).

¹⁷ On the criminal aspect of Shleifer's participation see note 9.

by the National Bureau of Economic Research as a shallow fall in gross domestic product of no more than a few percent, lasting at least six months, with a swift recovery thereafter.¹⁹ Russia's recession began in 1989, so applying their conceptual language must have ended before the Soviet Union dissolved. And of course, the 3.4 million excess deaths recorded 1990-1998 cannot be attributed to a hyper-depression which never occurred. These hapless souls must have been killed by a mild recession.

Besides these grave problems, it should be stated for the record that no serious macroeconomic critique of the G-7's handling of Russia's botched transition ever ascribed the hyper-depression to the "loans for shares" scandal. "Spontaneous" privatization 1988-91 under Gorbachev probably got the ball rolling, exacerbated soon thereafter by the corrupt "voucher privatization" Shleifer promoted with USAID funding, but the principal cause was the Yeltsin administration's "shock therapeutic" cancellation of most state contracts in the Spring of 1992. Before this blunder, enterprises enjoyed assured purchase. They depended on guaranteed sales to cover their expenses. Suddenly and without warning, they had no orders, no credit and no saleable products. It doesn't take a weatherman to know which way the wind is blowing. The US government cancelled all its contracts without compensation, there would be a severe depressionary impact, despite America's superior market efficiency?

Shleifer and Treisman similarly duck responsibility for the destabilizing consequences of the pathenogenic "assistance" they provided Russia on the U.S. government's behalf by blaming the Federation's 1998 economic meltdown on the Asian financial crisis. As John Kenneth Galbraith might have phrased it they give Asia too much credit for knocking down Russia's rotten door. Russia's financial crash was widely anticipated a half year before it occurred, without any reference to Asia, and Joseph Stiglitz insists that it was caused by the IMF's bad advice, not cured by it.²⁰

Moreover, Shleifer and Treisman assure us that neither the corrupt transfer of Russia's most valuable assets from the people to a handful of oligarchs, red directors,

¹⁸ Wedel (2001). Shleifer's and Treisman's comparison of Russia and the Ukraine is disingenuous. They use their own favorably adjusted figures for Russian per capita income and compare it with official Ukrainian data. If they didn't mix apples and oranges there wouldn't be any significant disparities.

¹⁹ Their fall back rationale is "the temporary dislocation that all countries experienced as their planning systems disintegrated." Apparently, they don't know that the Soviet system was also stabilized by guaranteed purchase and contracts, which made it profitable for enterprise managers to operate at full employment without planning.

kleptocrats and voucher privatization swindlers, nor mass involuntary unemployment (including "discouraged workers") were responsible for the quantum leap in Russia's gini coefficient from 0.26 in 1991 to 0.41 in 1994 because privatization came later. But spontaneous privatization began around 1988 under Gorbachev, and unemployment was vastly higher than Goskomstat reported, negating Shleifer and Treisman's mis-assertion. Nor can the gini coefficient post 1994 be trusted, since they acknowledge rapidly accelerating unemployment after 1994, and the continued asset grabbing by oligarchs and others right up to the present. Likewise, Branko Milanovic's finding that 77 percent of Russia's inequality increase is ascribable to the increasing importance of competitive wages may be eye wash. The World Bank study *Making Transition Work for Everyone: Poverty and Inequality in Europe and Central Asia, 2000* shows precisely the opposite result. Rising education premiums and wage dispersion explain very little of the rise in inequality. The causes of the huge rise lie "In the prevalence of widespread corruption and rent seeking, in the capture of the state by narrow vested interests, and in the resulting collapse of formal wages and income opportunities. People, except for the privileged few, are largely stuck in their low-paying jobs."²¹

Shleifer and Treisman do not flinch in defending "crony capitalism," and "oligarchy" either, assuring us that those who plunder the nation's patrimony have transformed themselves into world class entrepreneurs like John D. Rockefeller and J.P. Morgan. And they refuse to be intimidated by allegations of broader corruption, citing World Bank and EBRD surveys showing that Russia ranked "right in the middle of its postcommunist peers" in the "burden of bribery" and "state capture." There you have it, good criminals and normal crime! Can anyone begrudge Russia's Rockefellers their due for averting hyper-depression, killing millions with kindness, while preventing unjustified increases in inequality?

And they save the best for last. The opinion of the majority of experts and Russian human rights activists notwithstanding,²² Shleifer and Treisman assert that Russia has been

²⁰ Donald Rutherford (2000), p. 386. Joseph Stiglitz, "Rewriting History," *Johnson's Russia List*, No.6578, November 2002.

²¹ Ed Dolan, "Wolpin/Normality and Inequality/8087," *Johnson's Russia List*, No.8089, Article 16, February 27, 2004.

²² Sergei Kovalyov, a human rights legend, who spent 10 years in Gulag, recently wrote "It turned out that 13 yewars after the fall of the Soviet Union, the society does not require democracy." See Anna Badkhen, "Democracy on the Brink: Russia Back on Track of Absolute Rule," *Johnson's Russia List*, No. 8109, Article 1, March

wrongly accused of authoritarianism. "Russia's politics have been among the most democratic in the region. And the defects in the country's democracy resemble those found in many other middle-income countries." Since Stalin wasn't much different than Hitler, Mussolini, Franco and Hirohito, it follows on their logic that Soviet democracy was "normal," "among the most democratic in the region," a point they insist is confirmed in the post-Soviet case by frequently and fair elections. Pangloss never concedes anything substantial. He isn't perturbed by Standard and Poors' warning that foreign businessmen are vulnerable to Russian authoritarian victimization,²³ and isn't impressed by Grigory Yavlinski counter-assessment:

There are six major features of Russia which must be taken into account today. First, Russia has no independent judicial system. Second, since December, Russia has no elements of independent parliament. Third, Russia has no parliamentary control or oversight of the secret services and law enforcement agencies. Fourth, Russia has no politically important independent media. Fifth, elections in Russia are manipulated by the government. Sixth, the Russian economy is an instrument of the state.²⁴

Shleifer's and Treisman's mis-characterization of post-communist Russia as a "normal" middle income country is sound and fury signifying nothing, but their article does raise the more important issue of contemporary evidentiary standards. They aren't the first, nor will they be the last policy advocates to enlist elastic norms,²⁵ and massage data in order to seize the illusion of success from the reality of failure, and whitewash their transgressions. Can scholars do better?

Of course they can. Vilfredo Pareto, Abram Bergson, and Kenneth Arrow, building on the enlightenment edifice of Adam Smith worked out the essentials more than a half century ago (Abram Bergson, 1938, 1948, 1954, 1966, 1967, 1976; Samuelson, 1977, 1981; Arrow, 1963, 1981). The "good" society which Samuel Huntington identifies with

10, 2004. Cf. Stephen Blank, "Is Russia a Democracy and Does It Matter?" unpublished manuscript April, 2004.

²³ Alex Fak, "S&P Issues Authoritarianism Warning," *Johnson's Russia List*, No.8108, Article 4, March 10, 2004.

²⁴ Grigory Yavlinsky, Chairman of the Russian Democratic Party "Yabloko," "Russia: Before and After the Elections," Carnegie Endowment for International Peace, February 26, 2004, reprinted in *Johnson's Russia List*, No.8107, Article 11, March 10, 2004. The citation in the text is paraphrased.

²⁵ Wayne Merry, "A Normal Country," *Johnson's Russia List*, No.8087, Article 6, February 26, 2004. Merry stresses the issues Shleifer and Treisman conceal like Russia's crises in demographics, health, social structure, education and human capital.

the "idea of the west," (Samuel Huntington, 1996) is efficiently consumer sovereign both with respect to private and public goods. Efficiency here is Paretian. It means that given a voluntary Lockean social contract, and a corresponding fair play rule of law, individuals capable of rationally ordering their preferences and acting consistently on them, will seize every opportunity in education, training, employment, entrepreneurship, finance, production and distribution to maximize their utility, without coercing others. A system that generates these outcomes is consumer sovereign in the sense that supplies maximize individual utility, and hence social welfare under the conditions specified. Bergson and Paul Samuelson have shown the "plausible" existence of a Pareto class of social welfare functions, which allows individuals to voluntarily employ the state to acquire public goods, and redistribute income and wealth. The simplest of these welfare functions democratically determines transfers.²⁶

Kenneth Arrow as is widely known has demonstrated that elected representatives acting on behalf of many individuals cannot optimize as efficiently as individuals in Pareto market exchange. Consumer sovereignty therefore is not as ideal as one might hope, and the concept is under assault outside the economics profession by post-modernists who consider it a fig leaf for "capitalist" oppression, insensitive to progressive special interests and rights. But still Bergson argued that the democratic determination of public programs by elected officials is second best; that democratic free enterprise is likely to outperform its rivals.

This is the standard Sovietologists used to appraise the merit of the Soviet Union, and is the best measure of "normalcy" consistent with the idea of the west. It avoids conflating perversity with normality, twisting logic to deduce that what is normal is right.

The PBA (Pareto-Bergson-Arrow) standard easily dispels Shleifer and Treisman sophistry. A nation that has no independent judiciary, no independent parliament, no parliamentary control over the secret services, no politically important independent media and a public sector ruled by the state as Yavlinsky contends cannot be democratic, no matter how closely it approximates the CIS norm. Likewise, a country where an autocrat

²⁶ Bergsonian social welfare functions are defined in terms of the ethics of specific individuals, who judge the weights assigned each person's utility score. Although judges might find non-Paretian outcomes superior, Bergsonian social welfare functions prohibit them from coercing transactors. If judges are systems directors however, they can set transfers to maximize social welfare within this constraint. Bergson favored restricting their discretion further, arguing that transfers should be democratically determined. This rule has the virtue of simplicity, but many not always be superior to righteous counter-assessments.

creates and manipulates economic agents for his own purposes in the name of lofty social purposes, cannot be efficiently consumer sovereign. Outcomes are necessarily Pareto inferior even if Russia's qualitatively inferior growth statistics suggest otherwise.

It is useful to bear PBA in mind as well when contemplating the future. For reasons obvious to every neoclassical theorist, Pareto efficient, consumer sovereign democratic free enterprise should surpass the social welfare performance of authoritarian regimes. Theory teaches that perfectly planned, or perfectly mixed systems can also generate Pareto optimal outcomes, but the Soviet Union has demonstrated the improbability of satisfactory outcomes. Since no liberal democratic economy is perfect, this presumption isn't conclusive. Nonetheless, it is impermissible to assert as Shleifer and Treisman do that Russia's future will follow the positive trajectory of "normal" democratic, market middle income countries when Russia isn't a member of this set. The land of Rus isn't Mexico or Argentina.²⁷ The Kremlin plying its own unique rent granting, "patrimonialist" course, has tried unsuccessfully to keep pace with the west for more than half a millennium without abandoning its Muscovite brand of authoritarianism, and to date there is no sign of fundamental change despite Russia's return to pre-Soviet managed markets.

²⁷ The IMF and World Bank fresh from failure with the Latin American debt crisis were assigned the Russian "transition" portfolio by the G-7. Its Latin American experts at the time quickly assured outsiders that Russia and Mexico were essentially the same system.

Conclusion

Russia is everything Shleifer and Treisman deny, and some of the fault is Shleifer's. It is an abnormal country, shaped by aberrant forces which differ fundamentally from those of Mexico and Argentina. All non-Paretian systems aren't the same, and some like Russia degrade human welfare more than others. This judgment can be easily verified by applying PBA, instead the Shleifer's and Treisman's tactic of normalizing the abnormal. Their attempt to whitewash their transgressions, and obtain plaudits for failure isn't important in its own right, but does serve as a cautionary example of the way some policymakers distort public discourse by applying elastic yardsticks, and massaging the data.²⁸

²⁸ Policymakers of course aren't the only ones who knowingly glamorized Russia. The New York Times reporter Walter Duranty for example in September 1933 deliberately set himself the task of "discrediting" what he called the "campaign about the alleged famine." See Bertrand Patenaude, "Omelets, Eggs and Eggheads," *Wall Street Journal*, reprinted in *Johnson's Russia List*, No.8083, Article 30, February 24, 2004. Cf. Engerman, (2003). Rosefielde, (2003). Most of the "revisionist" political science literature, especially dealing with Soviet foreign policy suffered from the same tendency to depict the Kremlin as normal (benign).

References

- Arrow, Kenneth(1981). "Optimal and Voluntary Income Distribution," in Steven Rosefielde, ed., *Economic Welfare and the Economics of Soviet Socialism*, Cambridge U.P., Cambridge, 267-88.
- Arrow, Kenneth(1963). *Social Choice and Individual Values*, 2nd ed., Wiley, New York.
- Aslund, Anders(1997). "Russia Gets on Track to Be a Normal Country," *International Herald Tribune*, March 19, p.8.
- Aslund, Anders(1995). *How Russia Became a Market Economy*, Brookings, Washington, DC.
- Bergson, Abram(1938). "A Reformulation of Certain Aspects of Welfare Economics," *Quarterly Journal of Economics*, 52(1), February, 310-34.
- Bergson, Abram(1948). "Socialist Economics," in H.Ellis (ed.), *A Survey of Contemporary Economics*, Richard D. Irwin, Homewood, Illinois, 412-48.
- Bergson, Abram(1954). "The Concept of Social Welfare," *Quarterly Journal of Economics*, 68(2), May, 233-52.
- Bergson, Abram(1966). *Essays in Normative Economics*, Harvard University Press, Cambridge, MA.
- Bergson, Abram(1967). "Market Socialism Revisited," *Journal of Political Economy*, 75(4), October, 655-73.
- Bergson, Abram(1976). "Social Choice and Welfare Economics under Representative Government," *Journal of Public Economics*, 6(3), October, 171-90.
- Berkowitz, Daniel, Joseph Berliner, Paul Gregory, Susan Linz and James Millar(1993). "An Evaluation of the CIA's Analysis of Soviet Economic Performance, 1970-1990," *Comparative Economic Studies*, 35(2), Summer, 33-48.
- Blanchard, Olivier, Maxim Boyko, Marek Dabrowski, Rudiger Dornbusch, Richard Layard and Andrei Shleifer(1993). *Post-Communist Reform: Pain and Progress*, MIT Press.
- Blasi, Joseph, Maya Krumova, Douglas Kruse, and Andrei Shleifer(1997). *Kremlin Capitalism: The Privatization of the Russian Economy*, Cornell U.P..
- Boone, Peter, Stanislaw Gomulka and Richard Layard(eds.)(1998). *Emerging From Communism*, MIT Press.
- CIA(1992). *Handbook of International Economic Statistics*, CPAS92-10005, September.
- Engerman, David(2003). *Modernization From the Other Shore*, Harvard U.P. Cambridge.
- Firth, Noel, and James Noren(1998). *Soviet Defense Spending: A History of CIA Estimates, 1950-1990*, Texas A&M University, College Station.
- Fischer, Stanley and Ratna Sahay (2004), "Transition Economies: The Role of Institutional and Initial Conditions," Festschrift in Honor of Guillermo A. Calvo, April 15-16.
- Gaddy, Clifford and Barry Ickes(2002). *Russia's Virtual Economy*, Brookings, Washington, DC,.
- Gellis, David H.(2002). "Harvard in Settlement Talks with Forum," *Harvard Crimson*, October 30.

-
- Gellis, David H.(2002). "Harvard Settles with Mutual Funds Company Over Fraud Allegations," Associated Press, November 8.
- Huntington, Samuel(1996). "The West: Unique, Not Universal," *Foreign Affairs*, 75(6), November/December, 28-46.
- Kuboniwa, Maasaki, and Evgeny Gavrilencov(1997). *Development of Capitalism in Russia: The Second Challenge*, Maruzen, Tokyo.
- Maly, Matthew(2002). *How to Make Russia a Normal Economy (Kak sledat' Rossiuu normal'noi stranoi)*, Dmitrii Bulanin, St. Petersburg.
- Maly, Matthew(2004). *Russia As It Is: Transformation of a Lose/Lose Society*, 2004.
- Montefiore, Simon(2004). "Democratic Despot," *New York Times*, (Op-Ed),March 14.
- Rosefielde, Steven(1998). *Efficiency and Russia's Economic Recovery Potential to the Year 2000 and Beyond*, Ashgate, Aldershot.
- Rosefielde, Steven(2000). "The Civilian Labour Force and Unemployment in the Russian Federation," *Europe-Asia Studies*, 52(8), 1433-1447.
- Rosefielde, Steven(2001). "Premature Deaths: Russia's Radical Economic Transition in Soviet Perspective," *Europe-Asia Studies*, 53(8), 1159-1176.
- Rosefielde, Steven(2003). "The Riddle of Post Russian Economic Growth: Statistics Lied and Were Misconstrued," *Europe-Asia Studies*, 53(3), 469-81.
- Rosefielde, Steven(2004). "Postwar Russian Economic Growth: Not a Riddle-A Reply," *Europe-Asia Studies*, May 2004, vol. 56, No. 3, pp. 463-466.
- Rosefielde, Steven(2005). *Russia in the 21st Century: Prodigal Superpower*, Cambridge University Press, Cambridge.
- Rosefielde, Steven and Natalia Vennikova(2004). "Fiscal Federalism in Russia: A Critique of the OECD Proposals," *Cambridge Journal of Economics* 2004, 28(2), 307-318.
- Rossiskaia Federatsiia: Doklad o natsional'nykh schetakh*, Goskomstat, October 1995.
- Rutherford, Donald(2000). *Routledge Dictionary of Economics*, London.
- Jeffrey D. Sachs, Anders Aslund, Marek Dabrowski, Peter Reddaway, Igor Aristov, Wayne Merry, Michael Hudson, David Ellerman and Steven Rosefielde. "Tainted Transactions: An Exchange - response to Janine Wedel, and Webel's reply," *The National Interest*, No.60(Summer 2000), pp.98-110.
- Samuelson, Paul(1977). "Reaffirming the Existence of a 'Reasonable' Bergson-Samuelson Social Welfare Function," *Economica*, 44, 81-88.
- Samuelson, Paul(1981). "Bergsonian Welfare Economics," in Steven Rosefielde, ed., *Economic Welfare and the Economics of Soviet Socialism*, Cambridge U.P., Cambridge, 223-66.
- Shleifer, Andrei and Daniel Treisman,(2004), "A Normal Country," *Foreign Affairs*, pp. 84,2, March/April, pp. 20-38.
- Shleifer, Andrei and Daniel Treisman(2000). *Without a Map: Political Tactics and Economic Reform in Russia*, MIT Press.
- Shleifer, Andrei and Robert Vishny(2000). *The Grabbing Hand: Government Pathologies and Their Cures*, MIT Press.

-
- Tenet, George (2004), "The Worldwide Threat 2004: Challenges in a Changing Global Context, testimony before the Senate Select Committee on Intelligence, 24 February 2004, Washington D.C.
- UN(2003). *Economic Survey of Europe*, United Nations, No.1.
- Wedel, Janine(1998). *Collision and Collusion: The Strange Case of Aid to Eastern Europe 1989-1998*, St. Martin's Press.
- Wedel, Janine(2000). "Tainted Transactions: An Exchange," *National Interest*, Spring, pp.23-35.
- Wedel, Janine(2000). "Tainted Transactions: Replies," *National Interest*, No.60(Summer 2000), pp.98-110.
- Wedel, Janine(2001). *Collision and Collusion: The Strange Case of Western Aid to Eastern Europe*, New York, NY: Palgrave.
- Williamson, John(1993). "Democracy and the 'Washington Consensus,'" *World Development*, 21, pp. (8), 1329-1336.
- Williamson, John(2002). "Did the Washington Consensus Fail? Outline of Remarks at the Center for Strategic and International Studies, 6 November *World Development*. Available at <http://www.iie.com/publications/papers/wiliamson1102.htm>.
- Williamson, John(1989). "What Washington Means by Policy Reform, in Williamson, ed., *Latin American Adjustment: How Much Has Happened?* Institute for International Economics, Washington, DC, 5-38.

- 2003**
- No 1 Karsten Staehr: Reforms and economic growth in transition economies: Complementarity, sequencing and speed
 - No 2 Eugene Nivorozhkin: The dynamics of capital structure in transition economies
 - No 3 Abdur R. Chowdhury: Do asymmetric terms of trade shocks affect private savings in a transition economy?
Published in: Comparative Economic Studies (2003), ISSN 0888-7233. (Forthcoming.)
 - No 4 Byung-Yeon Kim and Jukka Pirttilä: The political economy of reforms: Empirical evidence from post-communist transition in the 1990s
 - No 5 Tuomas Komulainen and Johanna Lukkarila: What drives financial crises in emerging markets?
Published in: Emerging Markets Review vol 4, no 3 (2003) pp. 248-272, ISSN 1566-0141.
 - No 6 Jarko Fidrmuc and Iikka Korhonen: The Euro goes East: Implications of the 2000-2002 economic slowdown for synchronisation of business cycles between the euro area and CEEs.
Published in: Comparative Economic Studies vol. 46 no 1 (2004) pp. 45-62, ISSN 0888-7233.
 - No 7 Derek C. Jones, Panu Kalmi and Niels Mygind: Choice of ownership structure and firm performance: Evidence from Estonia
 - No 8 Michel Funke and Ralf Ruhwedel: Export variety and economic growth in East European transition economies
 - No 9 Laura Solanko: An empirical note on growth and convergence across Russian regions
 - No 10 Michael Funke and Holger Strulik: Taxation, growth and welfare: Dynamic effects of Estonia's 2000 income tax act
 - No 11 Jörg Rahn: Bilateral equilibrium exchange rates of EU accession countries against the euro
 - No 12 Toni Riipinen: Energy market liberalisation in the FSU—simulations with the GTAP model
 - No 13 Natalia Smirnova: Job search behavior of unemployed in Russia
 - No 14 Jesús Crespo-Cuaresma, Jarko Fidrmuc and Ronald MacDonald: The monetary approach to exchange rates in the CEECs
 - No 15 Julius Horvath: Optimum currency area theory: A selective review
 - No 16 Pertti Haaparanta, Tuuli Juurikkala, Olga Lazareva, Jukka Pirttilä, Laura Solanko and Ekaterina Zhuravskaya: Firms and public service provision in Russia
 - No 17 Michael Funke and Ralf Ruhwedel: Trade, product variety and welfare: A quantitative assessment for the transition economies in Central and Eastern Europe.
- 2004**
- Nro 1 Balázs Égert: Assessing equilibrium exchange rates in CEE acceding countries: Can we have DEER with BEER without FEER? A critical survey of the literature
 - Nro 2 Leena Kerkelä: Distortion costs and effects of price liberalisation in Russian energy markets: A CGE analysis
 - Nro 3 Julius Horvath and Stanislav Vidovic: Price variability and the speed of adjustment to the law of one price: Evidence from Slovakia
 - Nro 4 Pertti Haaparanta and Mikko Puhakka: Endogenous time preference, investment and development traps
 - Nro 5 Iikka Korhonen and Paul Wachtel: Observations on disinflation in transition economies
 - Nro 6 Eugene Nivorozhkin: Financing choices of firms in EU accession countries
 - Nro 7 John P. Bonin, Iftekhar Hasan, Paul Wachtel: Bank performance, efficiency and ownership in transition Countries
 - Nro 8 John P. Bonin, Iftekhar Hasan, Paul Wachtel: Privatization matters: Bank efficiency in transition countries
 - Nro 9 Balázs Égert and Kirsten Lommatzsch: Equilibrium exchange rates in the transition: The tradable price-based real appreciation and estimation uncertainty
 - Nro 10 Yuko Kinoshita and Nauro F. Campos: Estimating the determinants of foreign direct investment inflows: How important are sampling and omitted variable biases?
 - Nro 11 Akram Esanov, Christian Merkl, Lúcio Vinhas de Souza: Monetary policy rules for Russia
 - Nro 12 Greetje M.M. Everaert: The political economy of restructuring and subsidisation: An international perspective
 - Nro 13 Igor Vetlov: The Lithuanian block of the ECSB multi-country model
 - Nro 14 Michael Funke and Jörgen Rahn: Just how undervalued is the Chinese renminbi
 - Nro 15 Steven Rosefielde: An abnormal country

Bank of Finland
BOFIT – Institute for Economies in Transition
PO Box 160
FIN-00101 Helsinki

Phone: +358 9 183 2268

Fax: +358 9 183 2294

Email: bofit@bof.fi

www.bof.fi/bofit
