

Underwriting Democracy
Encouraging Free Enterprise and
Democratic Reform Among the
Soviets and in Eastern Europe

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Underwriting Democracy

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CHAPTER 2

The Collapse of the Soviet System

We are witnessing the disintegration of a closed system as embodied by the Soviet Union. The disintegration affects all aspects of the system, notably an ideology, a system of government, an economic system, and a territorial empire. When the system was intact, all those elements were integrated; now that the system is falling apart, the various elements are decaying in various ways and at various speeds, but events in one area tend to reinforce developments in the other.

The decay started a long time ago, with the death of Stalin. A totalitarian regime needs a totalitarian at the top. Stalin fulfilled that role with gusto. Under him the system attained its maximum extension, in both ideological and territorial coverage. There was hardly an aspect of existence that escaped its influence. Even genetics obeyed the Marxist doctrine. Not every science could be subjugated with equal success, but at least the scientists could be tamed and their contact with youth restricted by confining them in the Institutes of the Academy and preventing them from teaching at universities. Terror played a large part in making the system work, but the cover of ideology successfully concealed the underlying coercion and fear.

It is a testimony to Stalin's genius that the system survived him by some thirty-five years. There was a brief moment of hope when Khrushchev revealed some of the truth about Stalin in his speech before the Twentieth Congress, but eventually the hierarchy reasserted itself. A twilight period began when dogma was preserved by administrative methods, without any belief in its validity. Interestingly, the rigidity of the system increased even further. As long as there had been a live totalitarian at the helm, the system enjoyed some maneuverability: the party line could be changed at the whim of the dictator and the previous one excised. Now that flexibility was lost, and the system became rigid. At the same time the terror abated and a subtle process of decay set in. Every enterprise and institution sought to improve its own position.

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Since none of them had any autonomy, they had to barter whatever powers they had for the resources they needed for their own survival. Gradually an elaborate system of institutional bargaining replaced the central planning and central control that had prevailed while the system had been in totalitarian hands. Moreover, an informal system of economic relationships evolved to supplement and fill the gaps left by the formal system. The inadequacy of the system became increasingly evident, and the pressure for reform mounted.

Now comes a point that needs to be emphasized: reform accelerated the process of disintegration. It introduced or legitimated alternatives at a time when the system depended on a lack of alternatives for its survival. Alternatives raise questions; they undermine authority; they not only reveal discrepancies in the existing arrangements but reinforce them by diverting resources to more economic uses. A command economy cannot avoid a misallocation of resources: introduce a modicum of choice, and the shortages are bound to become more pronounced. Moreover, the profits that can be earned by diverting resources from the command economy are much greater than those that can be earned from productive activity; it is therefore not at all certain that overall production will benefit.

The fact remains that in every communist country, with the notable exception of the Soviet Union itself, there has been an initial improvement when economic reform has been introduced. The reason is that a command economy is so wasteful that any change is initially for the better. Only later does the damage done to the rigid structure of the centrally planned economy begin to outweigh the initial benefits obtained.

The Chinese reformers concluded, after a study tour of Hungary and Yugoslavia in 1986 sponsored by my foundations, that reform enjoys an initial ‘golden period’ during which an improvement in the allocation of existing resources gives people a definite sense of progress. Only later, when existing capacity has been redeployed and new investments are necessary does the reform process run into insuperable difficulties. At that point, political reforms are needed to make further economic reforms possible.

The communist system suffers from a fatal flaw, which cannot be remedied by reform:

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investments are hopelessly inefficient because capital has no value. It is understandable why this should be so: communism was meant as an antidote to capitalism, which had alienated the worker from the means of production. Communism claimed to protect the interests of the worker; therefore, the interests of capital could receive no representation. All property was taken over by the State, and the State was an embodiment of the collective interest, as defined by the party. That placed the party in charge of the allocation of capital. The party's allegiance, however, was with the workers, so it could not even recognize that capital also needed to be looked after. It was not just a matter of state ownership; it was a case of having no ownership at all.⁵ Capital is a scarce resource, just like labor or land, and needs to be allocated among competing uses. This basic principle of economics was ignored by the system of central planning as it evolved under Stalin.

A closed society calls for distortions that would be inconceivable in an open society. What better demonstration could one ask for? Economic activity under the Soviet system is simply not economic; it is better understood as the expression of some kind of quasi-religious dogma. Perhaps the best analogy is with the pyramid-building of the pharaohs. This interpretation explains why the portion of resources devoted to investment is maximized, while the economic benefit derived from them remains at a minimum. It would also explain why investment takes the form of monumental projects. We may view the gigantic hydroelectric dams, the steel plants, the marble halls of the Moscow subway, and the skyscrapers of Stalinist architecture as so many pyramids built by a modern pharaoh. Hydroelectric plants do produce energy, and steel plants turn out steel, but if the steel and energy are used simply to produce more dams and steel plants, the effect on the economy is not very different from that of the construction of pyramids.

That is why there is so much room for putting existing resources to better use. Redirecting existing resources is relatively easy, but when it comes to investment decisions, much more profound changes are needed. Capital must be treated as a scarce and valuable resource. A price must be put on capital and the rate of interest used as a guide in its allocation. This means, in

⁵ C.f. Roman Frydman and Andrzej Rapaczynski, *Markets and Institutions in Large-Scale Privatizations* (New York: New York University, C. V. Starr Center, 1990).

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effect, that the party must be removed from its role as the guardian of capital. It is on this issue that every reform is bound to come to grief: only a change that goes beyond reform and qualifies as a transformation of the system can hope to be effective.

This line of argument is well supported by the historical evidence. Both in Hungary and in Yugoslavia, and later in China, reform initially produced positive results. Its greatest success was in agriculture, where decentralization and the introduction of incentives led to higher output within a relatively short time. This gave the reform movement credibility on which it could draw later. The allocation of capital was not much of an issue, particularly in China, where practically no machinery is employed in agriculture. People just worked harder because they were allowed to enjoy the fruits of their labor. Outside of agriculture, reform consisted mainly of introducing a more realistic price structure and a more flexible plan, giving enterprises a greater degree of autonomy. In China, for instance, the plan called for the production of four items: bicycles, watches, sewing machines, and radios. Greater availability of those products gave people a sense of progress and helped maintain the momentum of reform.

Reform was a gradual process, directed from above. The difficulties also arose gradually. They had to do with the weakening of the center and the imperfect autonomy of the decision-making units. It is difficult to trace the process in general terms, because reform followed a somewhat different path in each country; it was intricately interwoven with political developments and took many twists and turns. I am not well qualified to provide a historical account, because I was not paying any particular attention until the last few years. But that may be an advantage, because it allows me to concentrate on the salient features.

Although enterprises were given increasing latitude, they were not converted into truly autonomous units. They remained responsible to the state or, more exactly, to the party, which was in charge of the state. Managements were members of the *nomenklatura*, the party system by which appointments were made to specific posts. Their appointment, as well as their removal, depended on the party apparatus. Direct commands from the ministry may have been replaced by indirect rules couched in monetary terms, but the lines of command remained the same. As a

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result, what was proclaimed as a market-oriented system was not really dependent on the market but remained oriented toward the sources of power.

There is always a divergence between the system as designed and the system as it really functions. When market-oriented reforms are introduced, the gap does not disappear, it merely changes shape. Direct commands are replaced by rules couched in monetary terms, but in practice the supposedly fixed market rules are subject to administrative adjustment.

Enterprises operate under what Janos Kornai called “soft budgetary constraints”: there are no real penalties for breaking monetary rules. Being members of the party-state hierarchy, managers find it more rewarding to try to change the rules in their favor than to play by the rules as given. This leads to the emergence of a small group of successful entrepreneurs, the “red barons,” whose success depends on their ability to manipulate the system. One need only look at Hungary as recently as 1989 to see how complex such a system can become: almost every large enterprise had a special set of taxes and subsidies that applied to it. Ostensibly, these were associated with trading within COMECON (Council for Mutual Economic Assistance); be that as it may, they affected the fortunes of the companies concerned more profoundly than any other factor.

In a quasi-market system, enterprises are not allowed to fail. Reformers may clamor for the introduction of bankruptcy procedures, but bankruptcy would generate unemployment, and unemployment would be an admission of the failure of the system. The political center, as long as it retains any power at all, resists bankruptcies, especially among the noneconomic pyramids of heavy industry.

Hungary has by now established quite a sophisticated two-tier monetary system, in which the central bank is supposed to exercise monetary control through commercial banks. Hungary is a member of the International Monetary Fund. Its agreement with the IMF calls for strict limits on the amounts of money in circulation and credit outstanding. But the limits cannot be enforced: enterprises simply do not pay each other. Suppliers have to wait in line to be paid when a debtor company receives money on its own account. Since the suppliers’ debtors are also

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standing in line, the phenomenon has spread throughout the economy, until now, in mid-1990, it affects some 60 percent of all enterprises. The nonexistent credit outstanding (in the form of accounts receivable) equals seven weeks of national production. No wonder monetary controls are ineffective! All this would change if companies were forced into bankruptcy: creditors standing in line would then lose money and so would be much more reluctant to supply goods on credit. Not until December 1989, when Hungary was on the verge of passing from reform to transformation, was the decision made to put fifty-one companies into bankruptcy—and, of course, it was never executed. There has been remarkably little progress even to this day.

In less advanced reform economies, institutional bargaining is all-important because there is no price put on capital and no penalty for its inefficient use. As a consequence, the demand for capital is practically unlimited. The allocation of capital, which in theory is the function of the central planning agency, is in practice determined by pulling strings within the bureaucracy. Even so, there is never enough to go around. Two outstanding facts about the Soviet Union during the stagnation period: the average time of construction of an industrial plant was around eleven years, and inventories amounted to almost a full year's production. No investment can be economic in such circumstances, in the sense of producing returns that would allow paying a realistic rate of interest. In other reform economies the situation was not half as bad as in the Soviet Union, but the problem of capital allocation remained the root cause of chronic macroeconomic imbalance.

China is a particularly clear-cut case. Before the crackdown, reform had made considerable headway. Production was soaring, but investment demand was growing even faster. Every province wanted its own bicycle factory, and every department along the Yangtse River its own container port. As a result, inflationary pressures became unsustainable. The reform faction of Zhao Ziyang pressed for changes in the management of enterprises but lost out, and political repression followed.

Inflation is the bane of reform. The system prides itself on stability. Yet as soon as any kind of market mechanism is introduced, a rise in prices becomes unavoidable on account

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of the pent-up demand. At first it is gratefully accepted, because a supply of goods at higher prices is much preferable to no supply at all. Prices for basic commodities remain controlled, but the amount the state has to spend on subsidies goes up. This raises the amount of money in circulation, so the pressure of demand on the rest of the economy increases. Because it cannot be satisfied, an overhang of unspent money accumulates. The urge to invest also becomes more pressing. When prices are stable, there is no penalty for investing unwisely; when prices rise, there is a positive inducement, because real interest rates turn negative. When wages are also allowed to rise, all hell breaks loose. It is very hard to prevent that from happening, because as the center weakens, enterprises become increasingly preoccupied with keeping their workers happy. When the workers start to organize, the pressure becomes irresistible.

I call the transformation of latent into manifest inflation the Polish disease, because it is in Poland that it has reached its apogee. But it occurred in Yugoslavia, the land of self-management, much earlier, and the process can also be observed, in various stages of development, in Hungary, China, and the Soviet Union. In Poland it reached fruition in 1989, when the political power center was paralyzed and the enterprises had to fend for themselves as best they could. “Real” wages rose some 30 percent, but of course they were not real, because production did not rise at all. In fact, it fell by about 8 percent. The difference was taken up by the so-called inflation tax, that is, the depreciation in the value of money while it is in the hands of the population. It took an ever rising inflation rate, reaching 1,000 percent near the end, to square the circle. The enterprises subordinated all their other obligations to paying their workers. They stopped investing, they stopped paying taxes, they even stopped paying their suppliers. At the same time, nobody wanted to hold zlotys. When a free market in dollars was legalized, zlotys became practically valueless in dollar terms. With the total value of money in circulation rapidly shrinking, the state had to print more and more to finance the budget deficit. That is why inflation spun out of control.

Once it is recognized that reform is a process of disintegration, it can be seen that the course of reform bears a remarkable similarity to the boom/bust pattern one can discern in stock

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markets. It starts off relatively slowly. At first it satisfies some of the aspirations attached to it and is thus reinforced. But when results begin to diverge significantly from expectations, the divergence also serves to reinforce the process: the shortcomings of the system become more apparent and its ability to resist change erodes, while the desire for change gains momentum. Political and economic changes mutually reinforce each other. As the economic influence of the decision-making center is weakened, its political authority is also undermined. It is bound to resist—after all, the primary instinct of every bureaucracy is to preserve itself—but its resistance will engender further attacks until the political objectives come to overshadow the economic ones, and destroying the center of power becomes the primary goal. At that point reform is superseded by revolution.

There is another factor that tends to play an important part in the process: foreign debt. Reforming regimes often try to alleviate the problem of scarcities by borrowing from the West. Unfortunately, they waste the borrowed assets just as they waste their own, because they do not have a proper system of capital allocation. Both Poland and Hungary borrowed heavily in the 1970s, but their investment plans were ill-conceived and inefficiently executed. Projects not only failed to pay for themselves but left the countries heavily encumbered by hard currency debt. Cause and effect are hard to disentangle in a reflexive process, but there can be no doubt that in each case a reform regime sought to justify itself by creating the illusion of progress. There is a positive correlation among economic reform, foreign debt, and subsequent inflation. This can be seen by comparing Poland, Hungary, and Yugoslavia on the one hand with Czechoslovakia, Romania, and East Germany on the other. The first group followed the route of reform, debt, and inflation; the second resisted reform and avoided debt and inflation, but remained hopelessly rigid and misshapen. Bulgaria combined the disadvantages of both.

With the advent of *perestroika* in the Soviet Union, the process of disintegration entered its terminal phase, because the reform was primarily political and, as I mentioned before, the ‘golden period’ was missing. As living standards started to decline, public opinion turned against the regime, leading to a catastrophic acceleration which is culminating in the total collapse of the

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system.

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The question poses itself: did the reformers anticipate the consequences of their policies? The answer is rather complicated. Undoubtedly, party and government reformers were motivated primarily by a desire to change the system and were willing to advocate half-measures, knowing full well that eventually further measures would be required. At the same time they probably did not fully anticipate the negative consequences, or they could not have advocated the policies so effectively. Of course, the policies enacted fell short of the policies advocated in many respects, and reformers could always claim that their prescriptions had not been followed. At any rate, they all got sucked into the process whether they supported the government or opposed it, because they came to believe that every problem had a solution even if the solution engendered a new problem. In other words, they became participants and as such were committed to the reform process. Even if they had reservations, they could not voice them; their only course was to remain silent.⁶ Thus the reform debate came to be dominated by an unspoken belief in the efficacy of a continuous process of reform, even though that belief, judged from today's perspective, was clearly wrong.

Reform must be equated with the disintegration of a rigid, closed, changeless system. The farther it proceeds, the more thorough the disintegration becomes. A continuous process must lead to indefinite decay. Only if there is a moment of discontinuity can the trend be reversed and a new system brought into existence. As I shall argue later, indigenous forces are not strong enough to reverse the trend by themselves. The process of disintegration must be superseded by a process of integration into Western society, and that process cannot be accomplished without assistance from the West. Lacking that, the process of disintegration will continue, and the universal closed society of the Soviet Union will break up into its component parts, but it will not be able to acquire and maintain the institutions or even the frame of mind of an open society.

6 The outstanding practitioner of silence was Janos Komai, who, after writing the most incisive theoretical analysis, meticulously kept himself above the fray until quite recently.

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Here I am concerned only with establishing the first step in this argument: I want to show that reform, both economic and political, is connected with the decay of the system in a reflexive fashion: decay invites reform and reform hastens decay. The point is obvious, once we look at reform from the standpoint of the system: the weakening of the center constitutes a deadly threat. But the point is far from generally recognized; indeed, it has hardly ever been made. Perhaps the only ones who recognize its full import are the hard-liners who oppose reform in any shape or form, and they are fighting a losing battle. The reformers see it far less clearly, which is not surprising. Until recently, it would have been detrimental or downright dangerous to emphasize this point. To equate reform with disintegration would have doomed reform. Even today it may give intellectual ammunition to the hard-liners in the Soviet Union, not to mention China. But we are too far along in an accelerating sequence to be concerned about it. It is exactly because reform is bound up with decay that the process cannot be reversed. There may be repression, as in Tiananmen Square, but the status quo cannot be re-established. The monopoly of dogma has been well and truly broken, and there is no point in paying lip service to it.

Reformers have had a hard time adjusting to changing circumstances. Until recently all discussion had to be couched in Marxist terms. Even today it is not really acceptable in the Soviet Union to question Lenin. Fortunately, Lenin went through many phases. One of them—the New Economic Policy (NEP) in which private enterprise was encouraged—provides a suitable ideological base for the current debate. Terms like “private property” are suspect: as recently as 1990 it was more politic to speak of “individual property,” as a major proposal submitted to the Supreme Soviet did. This is now no longer true.

The pace of events has accelerated tremendously, and it is hard enough to keep up with them without having to watch one’s words. But mental patterns developed over a lifetime are difficult to break. Having to abandon the dogma one has been trying to reform can be a disorienting experience. Reformers are doomed to disappear; they will be replaced by radical transformers on the one side and hard-liners on the other. A younger generation will come along, no longer burdened by the intellectual luggage of past struggles.

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I know from personal experience how difficult it is to adjust one's rhetoric to changing circumstances. When I started my foundation in Hungary in 1984, it was considered unnecessarily provocative to call it the Open Society Fund; in the second half of 1988 that probably would have ceased to be true. When I set up the Fund for the Opening and Reform of China in 1986, I was at pains to point out the connection between my concept of reflexivity and the Marxist concept of dialectics. Today people are singularly uninterested in the issue. In the Soviet Union I could truthfully present myself as an avid supporter of Gorbachev's new thinking, but I could not have said many of the things I am saying in this book. I may in fact become persona non grata when it is published. Events have moved at different speeds in different countries. In order to be able to function with my foundations I thought it best to keep my opinions to myself as an observer. Only in the last year or so did I begin to speak out; only since the collapse of the Soviet Empire in Eastern Europe have I been less concerned with the fate of my foundations than with making my views known and influencing Western policy. Hence this book.

When reformers become radicalized they must revise and reverse their attitude toward the center of power. As reformers, any step that weakened the center and distributed power seemed a step in the right direction. But radical transformation requires a functioning executive power. It is not enough to destroy the central power of a closed society; a new authority must be established that is strong enough to bring open society into existence. That is the main obstacle to the transformation of a communist system. How can the old center be destroyed and a new one, concerned with the development of a market economy, created concurrently? How can people switch from subversive to constructive activity or—even more difficult—carry on both at the same time? This became the central issue of the Shatalin Plan. (See Chapter 5.)

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Now we come to one of the most interesting questions in our inquiry: where does Gorbachev fit into the picture? There can be no doubt that he played a crucial role in bringing about the

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present situation. Without him, events in Eastern Europe would not have accelerated the way they did. He deliberately set about dismantling certain features of the Soviet system. Did he want to destroy the whole system? If so, why? And what did he want to put in its place? Did he want to change only certain elements of the system? If so, which ones and for what reason? Did he know what he was doing? To what extent do the results correspond to his expectations? We need some answers in order to understand what has happened in the Soviet Union and what is to be expected.

We shall probably never know the truth. Historical research will be able to establish many facts, but the facts will be subject to many interpretations. Participants act on the basis of imperfect understanding. Their views are both inconsistent at any given time and subject to change in the course of time. In the case of Gorbachev, the situation is complicated by the fact that he is not at liberty to say what he thinks at any given moment. His rhetoric has changed remarkably over time. Did his thinking change, or did the conditions change that influenced the way he expressed himself? For instance, he asserted in December 1989 that he was a committed communist. That he made the statement is a fact. What did it mean? That is a matter for conjecture. The conjecture can then be checked against other facts already known or yet to be established. It is in this spirit that I shall offer my interpretation.

Just as man created God in his own image, until recently I was inclined to do likewise with Gorbachev. I believed that Gorbachev's view of the world was not very different from my own. Specifically, Gorbachev considered the distinction between open and closed society to be the critical issue. In his mind, the transformation of the Soviet Union into an open society took precedence over all other objectives. That was the central point on which he and I were in agreement. We differed on many other issues. For one thing, he did not understand economics; for another, he was a Russian and imbued with its culture, which includes both the Soviet period and the epoch that preceded it. He was probably deeply committed to communism as an ideal of social justice and was not aware of the fatal flaw in its construction. We differed in all those respects, but I suspected that he shared my view of history as a reflexive process, or else he

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could not have moved as boldly as he did. He was also a good example of the participant with imperfect understanding; otherwise he might not have embarked on his adventure in the first place. Specifically, he did not realize that dismantling the Stalinist system was not sufficient to bring about a free society. He was driven by a desire to remove constraints, and his vision did not extend far enough to foresee the problems he would encounter at that point. That was not surprising. Who would have thought he would get as far as he did in destroying the old regime?

I realized that my interpretation would be difficult to reconcile with certain preconceived notions that were widely held, especially in the United States. We tend to believe that a leader's primary objective is to gain and hold power. Gorbachev, with his brilliant maneuvers in consolidating his position, seemed to fit the mold. Yet I did not believe that Gorbachev wanted power at any price, as witness his behavior over the Armenian issue when it first arose. In my view Gorbachev was almost as squeamish about spilling blood as President Carter. Admittedly, he had a hot temper—he showed it by arresting the Nagomo-Kharabakh committee when they insulted his wife—and his temper was running short. But I could not see him turning into a despot in the manner of Peter the Great. In particular, I could not see him presiding over the use of force in the Baltics.

Another of our cherished notions is that the primary concern of a leader is for the national interests of his country. We have been greatly influenced by the doctrine of geopolitics, holding that national interests are largely determined by objective factors, which exert their influence over whatever government is in power. The doctrine does not hold up when a superpower radically redefines its national interests. Nevertheless, established patterns of thought tend to linger, and it was still widely believed until quite recently that Gorbachev was trying to change the system in order to regain the power the Soviet Union would otherwise lose. Recent events have put the lie to this contention: by no stretch of the imagination can it be argued that the upheaval in Eastern Europe served to strengthen the geopolitical position of the Soviet Union, yet it was a push from Gorbachev that made the dominoes tumble. Events have reinforced my interpretation.

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Gorbachev's primary goal was the internal transformation of the Soviet Union. His recipe for accomplishing it was to break the isolation into which the Soviet Union had fallen under Stalin's rule and to integrate it into the community of nations. Thus, Gorbachev's foreign policy has been guided by internal considerations rather than the other way around. This is a point that foreign policy experts in the West, well grounded in geopolitics, found difficult to grasp.

Gorbachev's views on international relations were much better developed than the rest of his program. Indeed, the expression "new thinking" applied only to this sphere. It was also in this sphere that he could count on the most competent professional support. It is not an exaggeration to say that the foreign ministry was the only bureaucracy in the Soviet Union that was unreservedly committed to Gorbachev's policies. I was shocked when a foreign ministry official proudly told me some time in 1987 that "everything that has been done with regard to human rights has been done by our department." I felt it should have been done by the interior ministry. As recently as the summer of 1989, the foreign ministry set up an economics section, recognizing that the officials charged with foreign economic relations were not doing their job.

The vision of the world that guided Gorbachev can be an inspiration for us all. It is based on the concept of an open society. He spoke of belonging to a "European house." His remarks were badly misinterpreted. Where are the frontiers of Europe, people wanted to know, in the Ural mountains, or at Vladivostok? It seemed more convenient to draw the line at the Western frontier of the Soviet Union. But that is not what Gorbachev had in mind: he thought of Europe as an open society, where frontiers lose their significance. That is a thought worth cherishing. It envisages Europe as a network of connections, not as a geographic location. The connections are open and manifold. They encompass every aspect of thinking, information, communication and exchange, not just the relationships between states. Being open-ended, its scope extends beyond the continent of Europe: it includes the United States as well as the Soviet Union, not to mention the more recent members of Western civilization such as Japan.

This conception turns Europe into the ideal of Western civilization, the ideal of mankind as an open society. Within this conception there is a need for closer association between sovereign

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states, but the states do not define or dominate the activities of people. It stands in contrast with the concept of Fortress Europe. It is an extension of the concept of civil society to the international arena.

All this may sound very idealistic to Western ears, but it holds great appeal for people who have been deprived of the benefits of an open society. Whether people in the West can also resonate to it will have considerable bearing on the future shape of the world.

There have been previous attempts to translate similar ideas into reality, notably the League of Nations and the United Nations. In both cases, the institutions foundered because they could not protect themselves against totalitarian regimes: Mussolini and Hitler in the first case, Stalin in the second. It is noteworthy that one of Gorbachev's first gestures was to pay up the Soviet Union's arrears with the United Nations.

Perhaps because he attached such high hopes to his foreign policy, Gorbachev had much less clearly defined objectives in internal politics and economics. He wanted to give people an opportunity to express their will and had a ready-made instrument for the purpose: the people's councils, called Soviets, from which the Soviet Union derived its name. But he failed to think through the relationship between the Soviets and the Communist party. When the issue arose, at the Party Congress that reactivated the Soviets, he improvised a makeshift solution. He was even more vague in his plans for the economy.

Gorbachev ran into insuperable difficulties almost from the start on two counts: the economy proved incapable of reform, and the desire of the various nationalities for increasing autonomy could not be assuaged. One might add a third difficulty—the inability of the Soviet Union to maintain its hegemony over Eastern Europe—but because Gorbachev refused to treat it as a problem he did not have to contend with it. The first two were not so easily dismissed.

Gorbachev had great confidence in his own ability to lead. Therefore he did not feel the need for well-developed strategic plans. That was just as well. Had he considered all the difficulties in advance, he might not have had the temerity to embark on his course. Early on, in 1987, the Columbia University sovietologist Seweryn Bialer could argue convincingly that the

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Soviet Union could never follow China along a path of economic and political reform, because China was homogeneous while the Soviet Union was both internally and externally an empire that needed a repressive regime to hold it together. His analysis was valid, but Gorbachev was so determined to change the regime that he was not deterred by it.

Much has changed since I formulated this view. My own opinion of Gorbachev is less adulatory in 1991 than it was a year ago, but my criticism relates to his recent actions, not to his historical merit. Gorbachev has reached the limit beyond which he cannot keep up with the revolution he has unleashed. The turning point came when he narrowly missed the opportunity to throw his weight behind the Shatalin Plan. Before that, he had always managed to regain the initiative by taking a radical step forward, surprising the progressives who were about to give up hope and keeping the *apparatchiks* off balance just as they were about to close in on him. But Gorbachev was too deeply rooted in his own past to make the radical break that the Shatalin Plan demanded of him. He had qualms about introducing private ownership, especially where land is concerned, and he could not give up the territorial integrity of the Soviet Union. As he had indicated in many of his utterances, he could go back to an ideological Lenin but no farther. Most important, he could not escape the *apparat* he was trying to abolish, because he had failed to develop a new method of administration, appropriate to administering change.

The failure was not personal but generational. It applies to practically all the progressives whether or not they support Gorbachev. Boris Yeltsin, for instance, is much less able to transcend the milieu from which he stems than Gorbachev. Significantly, the Shatalin Plan was the work of people under forty. It is the tragedy of the revolution that it did not allow enough time for people of that age group to come to the fore. By contrast, Zhao Ziyang in China, whose economic reforms were much more successful, relied heavily on young people. It is a historic achievement for Gorbachev to have stayed in the forefront of the revolution he started as long as he did.

Gorbachev has lost his vision; he is floundering. It is possible to argue that he never had a vision, that he was simply seeking power, just as he is now clinging to it. In my opinion that would be a mistake, because it would imply that his view of the world remained constant while

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the world around him changed out of all recognition. I view history as an interplay between events and perceptions, and it fits that view much better to recognize that Gorbachev's thinking has changed in the course of events.

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I shall consider the problems of the economy and of the nationalities separately but, of course, they are intrinsically connected. I shall first try to answer the question, why was the 'golden period' of reform missing in the Soviet Union?

There are several factors at play. One is the almost total lack of comprehension about elementary economics that permeates the country and reaches the highest echelons of leadership. The contrast with China is striking. There, former Communist party General Secretary Zhao Ziyang was an accomplished economist, and he had a "think tank" of brilliant young intellectuals at his disposal. There is nothing comparable in the Soviet Union. A member of the Soviet top leadership, Alexander Yakovlev, told me in 1988, "We do not understand economics and we are afraid to ask any questions because we would betray our ignorance. We thought that our economists would know what to do because they were so good at pointing out the shortcomings of the system, but we have been bitterly disappointed."

Closely related to the lack of understanding was the lack of concern with economic issues. Gorbachev was primarily preoccupied with politics, partly because he had to capture the levers of power and partly because he believed, correctly, that political change is a precondition of economic change. He exploited brilliantly every instance of failure and used it for replacing people in power with his own nominees until he reached a position within the party which by traditional standards would be considered impregnable. Only then did economic issues come to the forefront of his attention. He could no longer blame others for the failures, yet his own nominees were not much better than the people they replaced. Thus, he had to start taking the blame. Moreover, the traditional yardsticks were no longer applicable in determining how secure his position was. An impregnable position within the party was no longer sufficient to protect

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him when the party itself was losing power.

Gorbachev made a serious error in failing to recognize that political change was merely a necessary condition, not a sufficient condition, of economic change. He had a rather naive belief in democracy: allow people to make their own decisions and they will make the right decisions. But business cannot be run on consensus. Within each organization there must be a well-defined chain of command. In the absence of autonomous business organizations, there must also be a chain of command for the economy as a whole. If the economy is to be restructured, someone must be in charge of the restructuring. No attempt was made to establish an authority suited to the purpose.

Managing change requires an institutional setting different from the kind needed to manage a system that aims to be changeless. For managing change Japan had the Ministry of International Trade and Industry; Korea had the Economic Development Agency; even China had the State Commission for Economic Reform. But the Soviet Union did not establish an appropriate organ. The existing structures of command were retained; only some of the faces were changed. The most important error, the one that can be held responsible for the breakdown of the economy, was the decision to decentralize prematurely. State enterprises were given greater autonomy before they were reconstituted as autonomous entities, and new forms of economic activity were authorized before their scope and mode of operations were properly defined. As I have mentioned before, reformers learned to regard any step that distributed power as a step in the right direction. Events proved how wrong they were.

The bureaucracy was totally unprepared for functioning in the new environment. They were adept at taking their cues from above. They had learned to watch which way the wind was blowing at the top and to position themselves accordingly. Gorbachev told them that the system had changed and they had to take responsibility for their own decisions. At first they mouthed the slogans of *perestroika* without really believing them, but then they discovered that the system had indeed changed and they were not subject to the harsh discipline of the past. They did what any bureaucracy would do in the circumstances: they avoided responsibility. The result was a

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paralysis in the decisionmaking process. Decisions took even longer to reach than before, and the gap between decisions and their execution grew even wider. Reinforcing the paralysis was the issue of nationalities and the desire of the republics for greater autonomy. The writ of Moscow simply ceased to rule in the outlying regions of the empire.

Several other factors can be cited in the failure of *perestroika* to produce any initial benefits. There was no residual knowledge of free enterprise to draw upon. Nor was there a large emigre community to provide support. Private enterprise, insofar as it got started at all, could derive much greater profits from exploiting the anomalies of the system than from incremental production. I know of a fertilizer company selling its production for hard currency in Finland, only to have it sold back to a Soviet agricultural complex at a higher price without even changing the label. I have met the head of a successful cooperative, Artem Tarasov, who shocked public opinion by paying 90,000 rubles one month as his Communist party dues (members are supposed to pay 2 percent of their income to the party every month). He told me how his enterprise bought surplus raw materials from state enterprises at a discount, then sold them abroad in a barter deal for computers, which they could resell in the Soviet Union at thirty times the official rate of exchange—giving them an overall profit margin of 90 percent!

On balance, incremental benefits from newly authorized forms of economic activity have amounted to less than the harm done by the disruption of the established forms. If you shake a rigid structure, it will collapse. That is what happened in the Soviet Union. The only reason economic life did not come to a complete standstill is that it had not relied purely on the formal structure in the first place. There have always been many informal arrangements, and they are becoming even more pervasive. I have heard of an unofficial trading organization that has some three thousand state enterprises as members.

Economic restructuring is sorely in need of a concrete experience of success. If only some desirable new product were to become widely available! People would have at least one piece of tangible evidence of what the future might bring. For instance, sanitary napkins manufactured by Johnson & Johnson would bring considerable relief to women still using

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primitive methods of protection to cope with their monthly period. Johnson & Johnson is, in fact, part of the consortium of U.S. firms that is trying to arrange a series of interconnected joint ventures. Negotiations went on for two years before the first deal (involving Chevron), which would produce the oil that would provide the hard currency for the other products, was finally concluded with the Republic of Kazakhstan. It is unlikely therefore that locally manufactured sanitary napkins will become available any time soon. Unfortunately, not much relief can be expected from any other quarter either in view of the long lead times involved. There is only McDonald's in Pushkin Square with its mile-long lines.

In the absence of positive results, public opinion has reacted adversely to the manifestations of free enterprise. There is a strong streak of egalitarianism in Russia whose roots go back before communism to the rural communes, called *obshchina*, which flourished after serfdom was abolished and which, in turn, harked back to the halcyon days of organic society before serfdom was introduced.

Since there is no understanding of economics, people confuse profits with profiteering. They do not realize that it is only the distorted price structure that makes the windfall profits possible. Instead of pressing for the abolition of price controls, they clamor for the suppression of private enterprise. There has been a severe backlash. Many of the rights given to cooperatives have been subsequently rescinded; *perestroika* is almost dead. There is now an attempt to revert to the way things were. But Humpty-Dumpty cannot be put together again; the economy is drifting into chaos.

. . .

Let me now turn to the issue of nationalism. This goes to the very heart of the Soviet Union. The ideological base of the Union is the universal creed of communism, but its territorial base is the Russian empire. After the Revolution of 1917 the empire fell apart, a number of autonomous republics were established, and a civil war ensued in the course of which power was consolidated in communist hands and the outlying regions were once again brought under central control. It is

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possible to view the civil war as Moscow's reassertion of authority over its dominions.

Stalin, of course, became an absolute ruler with more power than the czars ever had. During and after World War II, he enlarged the territory of the Soviet Union by annexing the Baltic states and taking over parts of Poland, Romania, and Czechoslovakia, not to mention Königsberg (Kaliningrad) and the Kurile Islands. In addition, he extended the sway of the Soviet Union over Eastern Europe. In speaking of the Soviet empire, we usually mean the countries that the Soviet Union used to dominate outside its own borders, but there is a patchwork of nationalities within the boundaries of the Soviet Union that were also subjugated by the Stalinist system.

This is not the place to review Stalin's policy toward nationalities. Suffice it to say that he had no more respect for nationality than for any other human attribute. His only concern was to make his system work, and he would not hesitate to move people around on a very large scale. A high proportion of the population was deported from the Baltic states to other parts of the Soviet Union and replaced by ethnic Russians. Similarly, hundreds of thousands of ethnic Koreans were moved from the maritime areas of Siberia to locations farther inland, ethnic Ukrainians replaced Poles in Lvov, Germans were deported from Kaliningrad to Saratov Province, and so on.

When Gorbachev loosened the constraints, various national resentments and aspirations began to find expression. That was what Gorbachev was hoping for: nationalist movements were his natural allies in shaking up the rigid power structure. He wanted to release spontaneous forces, but in Armenia and Azerbaijan they turned against each other and posed a deadly threat to his policy of liberalization. Gorbachev was mentally unprepared for the process he unleashed.

Nationalism has two faces. It is easy to distinguish between them. One is benign, cultural, seeking self-expression, and supportive of the aspirations of other nationalities. It is the nationalism that swept Europe in 1848. The other is primitive, violent, and directed against other nationalities. It is the stuff civil wars are made of. The benign form fits in well with the concept of open society; the vicious form is the breeding ground of closed societies. What is difficult to understand is the way the two faces are related to each other.

There can be no doubt that nationalist movements during the Gorbachev era started with a

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benign face. They gave rise to the popular fronts, which came to dominate political life in most of the republics. The popular fronts formed an alliance among themselves, the Interregional Group, that became, in effect, a parliamentary opposition pushing for more radical reforms (they qualify as left-wing in Soviet parlance, but right-wing in Western terminology). At the height of the Nagorno-Karabakh conflict in September 1989, when Gorbachev issued an ultimatum threatening military intervention in order to lift the economic blockade of Armenia, the Interregional Group arranged an armistice. Once again, at the end of January 1990 the Armenian and Azerbaijani popular fronts got together in Riga, Latvia, under the auspices of the Baltic movements to try to resolve their differences. But to no avail.

Nationalism in the Baltics has quite a different character from that in the Caucasus and the Asian republics. The Ukraine is yet another story. The leaders of the Ukrainian nationalist movement in Kiev, the republic's capital, are artists and intellectuals, while the principal city of the western Ukraine, Lvov, is inhabited by people who were allowed to take over the apartments of Poles after the war; nationalism has taken a more violent form in Lvov than in Kiev.

One can try to draw a distinction between different forms of nationalism according to the cultural traditions of the people involved. I believe, however, that there is a more interesting historical connection to be found between the two faces of nationalism. I suspect that nationalism is following the same boom-bust pattern as economic reform, and for much the same reason. The failure of the benign, 1848-type of nationalism to produce positive results is what tends to lead to a radicalization of the movement. Well-meaning artists and intellectuals get pushed aside, and bigots and roughnecks take over. This holds true in the Baltics as well as in the Caucasus.

Failure is the feature that connects the nationalist movements with economic developments. If they produced positive results, nationalist movements would remain benign; similarly, if it were to satisfy national aspirations, *perestroika* would have a chance to succeed. As it is, economic failure and nationalist bigotry reinforce each other. To be specific, the Baltic states are clamoring for independence. Having their own currency is an essential ingredient in that demand. But as long as the rest of the Soviet Union does not have a currency that fulfills the functions

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of money, introducing money in one part of the Union would cause tremendous disruption in economic relations with the rest of the Union. It is because these disruptions cannot be tolerated by the central authority that the demands for autonomy cannot be fulfilled. If the Soviet Union had a real currency, the legitimate aspirations of the Baltic countries could be fulfilled, and *perestroika* could proceed at different speeds in different parts of the country. That is perhaps the only hope for *perestroika* to succeed at all. Unfortunately, the Soviet Union is not in a position to turn the ruble into a real currency. (These ideas will be developed further in Chapter 7.)

I want to emphasize that there is nothing inevitable about the boom-bust pattern. It merely represents the course that events are most likely to take, the line of least resistance. If sufficient resistance can be mustered, the line can be interrupted at any point. Discontinuity is an inherent feature of reflexive patterns; otherwise, developments based on some kind of bias would be reinforced forever. In the normal course of events a trend has to go quite far before sufficient forces are generated to correct the bias that sustains it. But trends can be broken at any time, especially if exogenous forces come into play. In this case, where could such forces come from? In my opinion, only from the West.

I shall try to be more specific and sketch out a particular path that the line of least resistance is likely to take in the absence of Western assistance. Needless to say, it is only one of many possibilities, but it happens to have greater probability than others have. As events climb the decision-tree, the odds may shift. So there is no historic inevitability about my prediction.

The clamor for autonomy and independence in the republics and the desire of the center to maintain the integrity of the Union are on a collision course. The center will find it difficult to resist the demands of the republics. Gorbachev showed himself reluctant to use force at the time of the first Armenian-Azerbaijani conflict. That was a watershed: the rule of terror was over, and it was replaced by persuasion. Gorbachev is a master of persuasion, but arguments cannot suppress the legitimate demands of the people—and the revelation of the secret clauses in the Molotov-Ribbentrop pact, which ceded the Baltic republics to the Soviet Union, has rendered the demands of the Baltic republics legitimate. Gorbachev has gone on record as saying that

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the Soviet Union cannot countenance the independence of the Baltic states. This puts him into an untenable position. Whatever compromise he manages to work out, it is bound to result in a further weakening of central authority. In my opinion, Gorbachev is more vulnerable in the Baltic republics than in Azerbaijan and the other Asian republics. In Asia he can use force, but in the Baltics he cannot. Even if he were replaced by a hard-liner, Soviet rule cannot be maintained by force, because the soldiers cannot be counted on to follow orders. There is simply not enough force in the Soviet Union today to cow the Baltic people into submission. What hard-liner wants to be in charge if he cannot use force? Therefore Gorbachev's position is more secure than it seems, but at the same time the authority attached to his position is likely to erode. A weakening of central authority would merely accelerate the process of disintegration. Gorbachev's disappearance would make it final. It is impossible to predict how far the process will go, but it is quite likely to culminate in a breakup of the Soviet Union. After all, the Russian empire also broke up when the czarist regime collapsed.

The more independent the constituent republics become, the more likely it is that a reactionary nationalist regime will take over in the Russian republic. Such a regime will have a century-old anti-Western and anti-Semitic intellectual tradition behind it. The similarity with Nazism is not incidental: they have common philosophical roots⁷ and will have a similar sense of national injury to draw on. With the economy in shambles, the regime will have no choice but to follow a revanchist, expansionist policy. With atomic weapons widely deployed, one is tempted to conclude that a new Russian nationalist regime would pose a greater threat to the world than the Soviet Union ever did. The Soviet Union, as we can now see, was essentially moribund; while it managed to maintain a threatening posture, it was very careful how it moved, because it was aware of its own fragility. The new regime would be out to prove itself, and the only means at its disposal would be military force. Fortunately, atomic arsenals become useless after a while (it has to do with the half-life of tritium), so the threat may be regional rather than global.

There is nothing inevitable about this scenario, but if nothing is done to prevent it, it is what is most likely to happen. What should the West do? That is the question I shall address in the

7 See Alexander Yanov, *The Russian Challenge* (Oxford: Basil Blackwell, 1987).

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next chapter.