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Private Property is the *Sine Qua Non*

Christopher DeMuth*
February 1992

Less than two months after its inception, the Russian government's bold program of price decontrol is widely regarded as a failure. It is wildly unpopular, it has failed to stimulate increased supplies of food and other essentials in the cities, and it has produced pricing anomalies as absurd as those under the old system of state-administered prices.

President Yeltsin's advisers talk bravely of the ultimate success of price decontrol and emphasize, correctly, that the program's reception has been confounded by severe ruble inflation, which can be cured only by a stable money supply backed by adequate reserves, perhaps with assistance from the West. Yet the unpopularity and ineffectiveness of something so fundamental to the market economy as pricing freedom, and the widespread confusion it has engendered, seem to augur poorly for economic reform in Russia and the other fledgling C.I.S. republics. The pessimists who have argued that Russians are ill-equipped by temperament and tradition for a market economy appear vindicated before the economic transition has really begun.

But the Russian price reform program has an even deeper flaw than its introduction before currency stabilization. It is that prices were freed in the absence of private ownership, while the means of production remained largely in the hands of the government bureaucracies. The theory of price -- that prices coordinate supply and

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demand by generating information about consumer preferences and the availability of resources to meet those preferences -- assumes that resources are owned by those who price them. With private ownership, price (and quality) competition among sellers yields prices that just cover costs of supply and clear the market; without ownership, prices are unhinged from economic interest and perform no useful or even predictable social function.

Imagine that the executives of the General Electric Company decided to "decontrol" the prices of all of the thousands of goods and services the company produces -- announcing to managers and salesmen that they could charge any prices they wished, and that their salaries and career prospects would be unrelated to their sales or profits. Salesmen might slash prices to curry favor with customers, or they might raise prices to discourage sales and leave themselves with less to do; probably they would do both, favoring customers who could do them personal favors in return but otherwise pursuing the quiet life rather than sales and profits. GE's prices would no longer perform any economic function and its business prospects, needless to say, would be exceedingly poor.

This is approximately the situation in Russia today. A recent news report described a baker who increased her prices sharply in the wake of decontrol; discovering that the new prices left her not only without the familiar queues but without any customers at all, she simply closed up shop for the day. (She said she was returning the bread to a government depot, but I'll bet some of it got "sold" to family and friends at a steep discount.) I have heard this story cited as evidence of the economic ignorance of ordinary Russians and of the need for Western technical assistance in the form of economic education programs. But given that the production, distribution, and sale of bread remains a state enterprise in Russia, the baker was pursuing her economic self-interest to a T. If she had owned the shop or its wares or had been employed by someone who stood to benefit from selling at a profit, she would have promptly figured out what prices would bring customers back into the shop.

There is another, subtler reason why the Russian reformers have put the cart before the horse in decontrolling prices before establishing private ownership. Private ownership is essential for the effective operation of a free economy -- but it is also essential for the effective operation of an *unfree* economy. Western free-marketers might imagine that formerly Communist nations, enlightened by bitter experience, might now form the vanguard of a new era of laissez faire; but this is a daydream. As these nations become more democratic, and their intellectuals and reformers lose influence to elected legislatures, their economic policies will increasingly reflect the mixture of populist sentiment and interest-group machinations long familiar in the West. Indeed the popular reaction against Russian price decontrol is the beginning of this evolution. In this environment, characterized by a profusion of government policies that seriously damage the efficiency of private markets (by accident or design, for purposes worthy or unworthy), private property and the incentives it creates are critical to economic welfare and progress.

Consider that the American economy has performed admirably over long periods despite grossly inefficient regulatory controls over prices, entry, investments, labor relations, and much else, and that these controls have been particularly extensive in such critical sectors as transportation, energy, communications, and finance. An important reason for our success is that even our most heavily regulated industries have been privately owned and managed: private property and the relentless pursuit of private economic advantage have furnished an economic safety net beneath accident-prone regulators.

Regulated firms, by eking out profitable business arrangements under whatever rules the government has set, have mitigated the effects of bad policies. When the government fixed airline fares above costs of service, airlines resorted to service-quality competition; when the government fixed doctors fees below costs of service, doctors substituted laboratory tests for office visits. The results are not ideal, but they are second-best: they hold the social costs of price controls to a minimum.

And when regulated firms have been unwilling or unable to escape the confines of government rules, unregulated firms have often fashioned creative market responses outside the rules. When the pre-divestiture AT&T learned to love its politically correct rate structure, under which business customers subsidized residential customers, upstart microwave communications firms rushed in to capture the high-markup business. Similarly, money market funds and other unregulated financial services have exploited the manifold inefficiencies of banking regulation to the immense benefit of savers and the U.S. economy generally.

Private economic interest does more than generate beneficial market responses to government policies. It also generates political action to influence the policies themselves, with results that have not always been beneficial. Academic journals and the popular media describe the alacrity with which U.S. corporations set aside free-market principles to lobby for regulatory barriers to competition, tweaks in the tax code and environmental statutes that favor particular firms or industries, and other special-interest arrangements. This is indeed a lamentable feature of the free-wheeling, anything-goes regulatory state that American government has become, but it is not an argument against the active participation of producers and property owners, along with consumers and other groups, in the political process.

In Russia and the other C.I.S republics today -- with massive state-prescribed inefficiencies afflicting every aspect of production and distribution, and with millions of government bureaucrats working diligently to sabotage reform -- the entry of property-owning, profit-seeking entrepreneurs, shopkeepers, farmers, industrialists, and financiers into the political fray is not just desirable but essential for sustainable economic reform. So far, from the beginnings of Mikhail Gorbachev's *perestroika* to the wholehearted embrace of the free market by Boris Yeltsin's advisers, economic reform has been the project of a few hundred intellectuals. What it lacks is a political constituency whose interest in economic liberty is tangible rather than theoretical -- groups and individuals that will lobby and electioneer for deregulation, stable money, foreign investment liberalization, and other reforms, and then make the best use of whatever (inevitably imperfect) policies result. The only way to accomplish that is through massive conversion to private ownership of land and other natural resources, commercial and residential real estate, factories, refineries, warehouses, and anything else of potential economic value, followed by the establishment of legal institutions to secure private property and facilitate transactions on mutually agreeable terms.

There are many approaches to this task; as Eastern Europe's more experienced reformers can attest, all are fraught with political and ethical as well as technical difficulties. The Yeltsin government has introduced legislation for privatizing farmland, residences, and other basic resources, but these proposals have met strong resistance in the Russian parliament. Rather than making a fight of it, Yeltsin's reformers have busied themselves with other, less contentious projects, such as price decontrol and seeking favor with the World Bank and the IMF.

The Russian reformers may feel they have so many things to do that they should simply follow the paths of least political resistance, abandoning hope of introducing reforms in any logical sequence. There is, however, another, more discouraging possibility. The arguments presented in this article are both old and new. Two centuries ago, Adam Smith observed that "the natural effort of every individual to better his own condition, when suffered to exert itself with freedom and security . . . [is capable of] surmounting a hundred impertinent obstructions with which the folly of human laws too often incumbers its operations." Three months ago, economist Ronald Coase received the Nobel Prize for his work expounding the legal and institutional underpinnings of the market economy and demonstrating (this is the heart of the "Coase Theorem") the strong tendency of markets to compensate for externally imposed rules. But between Smith and Coase, academic economics fashioned a highly abstract and disembodied conception of the economy, in which prices and investment and consumption work automatically, indeed arithmetically, to produce a social equilibrium. I do not know what textbooks the Russians have been studying, but freeing prices, without regard for who would use this freedom and how they would use it, is just the sort of thing a reader of many modern economics texts would be inclined to do.

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