

JERUSALEM LETTER / VIEWPOINTS

Jerusalem Center for Public Affairs

VP:120 7 Heshvan 5752 / 15 October 1991

THE ISRAELI PARADIGM FOR A CAPITALIST SOVIET UNION

Manfred Gerstenfeld

How to Change an Economic System? / Impact on the West / No Known Examples / Limits of the German Paradigm / Elements of the Israeli Experience / The Human Factor / Examples of Cooperatives / Saving and Finance / Making Twinning Meaningful

How to Change an Economic System?

Not much has remained of the euphoria of most Soviet citizens over liberalization. Concrete problems dominate abstract concepts. Change is a necessity. It can either come by itself in the form of chaos, or it can be steered gradually toward a society which will be radically different from the centrally planned one of communism.

Since the Iron Curtain was lifted it has been demonstrated that political change is much easier and less painful than economic change. Once one abolishes the monopoly of the Communist party and the subjection of the state to it the process can gain its own momentum. Constitutions can be drafted on the basis of what exists elsewhere and adapted to specific local conditions.

New parties emerge fast; the organization of relatively free elections has proven not to be a major obstacle. While there are many frictions, the

transition to a reasonably democratic political process in the Soviet Union is neither impossible nor need it take a very long time, as the experience in Hungary, Poland and Czechoslovakia has shown.

In the economic field transition is of a totally different nature. Many new laws adopted after perestroika are only partly applied. Even if the bureaucracies wanted to enforce them, they often do not know how to do this.

Public property has to be privatized in a system in which supposedly no significant private capital exists. The housing sector, to a large extent in public hands, supports major monopolies, including those in charge of maintenance and repairs. Unemployment has to be limited in a society where supply and demand of goods will be determined by uncontrollable diffuse market forces instead of by a relatively predictable central planning authority.

Even if one can broadly design the

Daniel J. Elazar, Editor and Publisher; Zvi R. Marom, Associate Editor; Mark Ami-El, Managing Editor. 13 Tel-Hai St., Jerusalem, 92107, Israel; Tel. 02-639281, Fax 972-2-639286. © Copyright. All rights reserved. ISSN: 0334-4096.

key parameters of the economy one wishes to construct, nobody has a concrete idea on what the practical steps are to get to the desired target and how long it will take. Even more important, nobody knows whether the frictions involved will not be such that chaos may become the dominant characteristic of the system.

Impact on the West

The orderly change of Eastern European economies and in particular the Russian one is not only important for those who rule and live in those societies. The nervous reactions in the West during the August coup in the USSR have demonstrated how relevant the major problems in the East are to the First World. The potential migration pressure from Eastern Europe is only one of the more obvious threats. Renewed disorder in the Soviet Union might mean an increased nuclear risk to the world at large.

It is thus not solidarity or generosity which one has to recommend to the West but farsightedness and enlightened self-interest. In the Marshall Plan, one of the greatest successes ever of enlightened international democratic policy, both elements were available. On the one hand, the desire to help; on the other hand, the strengthening of the democratic process in Western countries against a common enemy -- Soviet-dominated communism.

At present the common enemy of democracy in the West and the USSR is more diffuse. The democratic forces in the Soviet Union have to be strengthened against a variety of opponents who wish to turn away from anything that smacks of "the Western idea."

An orderly approach to the East's economic problems is particularly important at a time when the West is being solicited by all the Eastern European countries for major financial assistance. It is also timely as American and Russian experts are preparing plans that include the political trade-offs of economic assistance.

The results of Western assistance to many countries in the past differed from case to case. Sometimes there was a big

multiplier; in others most of the money was wasted. The history of aid teaches us at least one key lesson: money alone is rarely effective. Software aspects, i.e., know-how, training and guidance, are crucial for success.

No Known Examples

In addition to the political problems involved in a major system change, the major uncertainty of the desired transition to market economies in Eastern Europe is the lack of empirical examples anywhere in the world for such a total change. Nobody thus can predict how effective the methods used and the steps taken to substitute central planning will be. There are no other countries that have served as pilot projects and there is not much time to experiment. Thus the dangerous road of starting processes of full-country scale has to be followed.

In the absence of any overall experience of how to convert a communist system in an orderly way, the best one can do is to assemble in other countries some potentially relevant fragments of past development processes. These snippets of experience, put together and analyzed professionally, can be most useful in supplementing theoretical models.

Limits of the German Paradigm

Fragments of potentially useful experience to prepare the desired transition are scattered all over the world. At first sight one would be inclined to look for solutions in today's Germany since unified Germany daily gives many indications of transition problems. However, the usefulness of the German experience as an example for Eastern Europe to follow is limited. West Germany is making transfer payments to the former East Germany on an order of magnitude far beyond that of Western aid available for other countries behind the former Iron Curtain.

In spite of all the money transferred to the new member states, the German government may have misjudged what the massive unemployment means for the social fabric of the former East Germany.

The market economy has been imposed shockwise on the inhabitants of East Germany at an unrealistically high exchange rate. At the same time, the classic export markets for East German produce to the other former communist countries have fallen away.

In the monetary union at this exchange rate, political short-term considerations triumphed over economic logic. The exodus of migrants from East Germany to West Germany had to be stopped. After this policy had created an intentional economic distortion, letting free market economics loose on a wholly unprepared and uncompetitive society had, in turn, to cause major political problems.

Such a radical cure, with the accompanying destruction of employment, should thus mainly serve as an example of what not to do elsewhere. System changes have to be gradual. The change from a communist society to a liberal democracy is not only an economic, but also a cultural, psychological and social process. Multidisciplinary transition cannot be achieved by predominantly economic measures.

Elements of the Israeli Experience

It is strange that, in its short history, small Israel probably has more experience relevant to developing transition policies than any other country. This is not because the Israeli economy is, after the demise of communism, the one remaining functioning near-Soviet economy, as some cynics occasionally remark. To the contrary, while there is major state interference in many sectors of Israeli society, central planning plays a very limited role in many key sectors of the economy. Where centrally-planned economies are extremely rigid, the Israeli economy is in certain areas exceptionally flexible, due to the fact that the key policy-makers in government and the business sector have learned to live with unforeseeable outside factors which frequently emerge.

The elements of the Israeli experience which can be useful to a restructuring of the Eastern European economies derive from such factors as its heterogeneous

population, its rapid initial development, the multiple changes in its economic policies, its lengthy experience in development assistance, as well as its unique political situation.

One of the characteristics of Israel's economic policies is that in its short history so many different policies have been tried. We have had a great variety of taxation schemes, some extremely complex, others more simple. At certain moments the marginal tax rates applied to relatively low income levels were among the highest in the world. We have had an almost infinite experimentation with exchange rates, including a great variety of schemes applying multiple rates.

Price control and other artificial pricing has been applied in a number of different ways. Incentivation tools have been tried by the hundreds in a great variety of areas. The economy has functioned without stable prices and during exceptionally high inflation rates. There has also always been in Israel a close interaction between government, business and the trade unions.

The great variety of policies applied makes analysis of policies proposed much easier. Much can be learned from Israel's positive experiences. The country had an exceptionally high growth rate in the first two decades after independence. Much can also be learned from its multiple mistakes.

The Human Factor

A key element of Israeli know-how is that a great number of former Russians live in its territory who have privately made such a transition from a centrally planned economy to a market economy. This has required a major change in personal attitudes. These former Russian citizens are familiar with both systems. Their ability to mediate between Western business culture and a Russian entrepreneurial, business and market culture to emerge, provided it is applied appropriately, is priceless.

The fact that Israel is to some extent a hybrid economy makes this experience even more valuable. It is not only

unrealistic but also dangerous to convert the USSR economy to a fully free market in a short time. A somewhat mixed economy such as Israel is a better example to learn from than a much freer market such as the United States.

Since Israel is not a rich country, the nature of its development assistance has always had a high software content. As many experts claim that the Russian problem is not lack of resources but mismanagement and lack of experience, this may make Israel's development assistance even more valuable.

Since Western funds made available will be limited, making good use of them is important. Israel has, relative to its population, a high number of individuals who have experience in providing development assistance. To have part of them, as well as Russian immigrants who came here in the early 1970s, assist the Soviet Union or some of its constituent republics on the road to a liberal democracy may also make a small contribution to alleviate Israel's unemployment problems.

Another meaningful aspect of Israel's economic history is that there has been an, albeit gradual, transition from a state which wanted to be socialist in the late 1940s and early 1950s to a hybrid market economy. Studying the nature of this change and the success factors behind the rapid development of Israel's economy over several decades might yield important insights.

Examples of Cooperatives

In the transition of the Soviet economy, cooperatives are bound to play a major role. In sophisticated capitalist economies cooperatives usually are of very minor importance. However, in a society where individuals have yet to learn the rules of entrepreneurship and the market, and hardly any individuals do have significant funds available for investment, they provide an important mechanism of privatization. The incentivization of their establishment and proper functioning should thus be an important policy goal.

Israel has a significant trade union and

cooperative sector. There has been much discussion on its problems. However, it has functioned relatively competitively next to private enterprise for many decades and is still of importance. Thus its experiences cannot be discarded.

To this has to be added the experience of the kibbutz sector, which has maintained itself as an internal socialist economy next to an external market one. As the kibbutzim on a small scale to some extent executed what the Soviet Union wanted to achieve as a state, useful fragments of experience can probably be found here. The kibbutz is also an important example of how entrepreneurship can be created in a nonhierarchical society.

The joint industrial ventures of kibbutzim with private outside investors could offer particularly interesting examples of operational patterns for business ventures between collectives and individuals. Some experts consider that moshavim might serve as an even more useful example for the transformation of the Soviet agricultural system.

Saving and Finance

Interesting experiences can also be found in the fields of saving and finance. Some of the saving schemes applied in Israel, which have provided the capital for industrial expansion, are another area of experience which merits deeper investigation. While it is unlikely that one would want to export the cost-of-living linkage system so specific to Israel, some elements of it could be of interest, in particular, during a transition period.

In view of the Soviet food crisis, the development of agricultural credit is another priority sector. Israel has advised many countries in establishing agricultural credit schemes and its experts are frequently consulted internationally.

The establishment of a stock exchange is an important tool in the raising of finance for entrepreneurs. The small Tel Aviv exchange, which had to improve its operations rapidly and adapt to overcome a multitude of abuses and problems, might provide a more adequate model than more

established exchanges. Wall Street's sophisticated experience is hardly relevant to Moscow.

Israel also has a long history in the incentivization of entrepreneurship. Many different schemes have been tried and both positive examples and faults to be avoided can be found here. One such area involves the science-based industries, where scientists came out of the ivory towers of academia in the 1970s and 1980s to start up business ventures. While the gradual deterioration of academic salaries had a role to play, it was only one of the factors. In few countries has such a rapid change of mentality among academics taken place.

Incentivization of applied research and development is another field in which Israel has experience. Since foreign firms ought to be relatively willing to sponsor research in areas where the Soviet Union excels, the Israeli experience on how to protect that know-how against the abusive aspects of foreign exploitation may be useful.

One of the consequences of Israel's political isolation has been that the country's international trade is not with neighboring countries but with economies located much further away. This has given the government of Israel an important role in the development of a variety of both financial and software assistance schemes, which in part could be copied.

Taxation is another important field in which Israel has frequently changed policies and undertaken what in retrospect seems to be full-country scale experiments. In the Soviet Union's transition to a market economy, a well thought out tax policy will have to be a key factor.

Making Twinning Meaningful

Israel's long experience in obtaining funding for joint international research could be useful for establishing triangular, Western-Russian-Israeli projects. Many Israeli institutions such as universities have an extensive background in collaborating with institutions abroad.

Much more important though is the transfer of know-how collected through

Project Renewal. The twinning of cities in the Western world is a minor and rather symbolic act. It largely involves some cultural exchange as well as the opportunity for some senior officials to travel abroad. Yet Project Renewal followed a very different pattern. Jewish communities from abroad have brought their abilities to bear in order to solve part of the social and infrastructural needs of development towns.

It is far too idealistic, in view of the very low solidarity of Western society with anybody, to expect in East-West relations anything near the intense relationship of Project Renewal. However, twinning of Western and Eastern towns might be developed in a somewhat meaningful project. If a Russian city were twinned with a Western city, the major economic, social and cultural organizations of the latter might be convinced to offer some assistance to the Russian city. This could be of particular importance at a time when transition has to be initiated. It might also give the Russians the feeling that they are not alone.

Economists often erroneously tend to consider the problem of how to convert a centrally planned system to a market one as an economic question. It is, however, a much more complex and multidisciplinary problem. Because of the importance of the human factor, the development of twinning and similar schemes could be of crucial importance for a successful transition.

The examples mentioned above involve only some of the relevant experience Israel might have to offer Eastern Europe and the Soviet Union. Now that the standard of central planning has been irreversibly broken, Israel's unique economic experience can be a most valuable asset in designing the practical transition to a more market-oriented system.

* * *

Manfred Gerstenfeld, an Overseer of the Jerusalem Center for Public Affairs, is an international strategic consultant to the senior ranks of business and government.