

# Dual Economy in Russia Today\*

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## Introduction

The phenomenon of a dual economy in the modern world becomes more and more explicit for larger countries in transition to market. China and Russia are the two most impressive examples. In China the duality of the economy is acknowledged officially to some extent. Measurement of economic performance in terms of statistics takes into account the dual price system[see, Xu (1993)]. One can learn what amount of production is done at state prices and respectively at market ones.

In this paper I analyse the duality of the Russian economy in the two aspects. First one is expressed by the two prices for the same product: rigid state prices and flexible market ones. It is related to the state and private sectors of the economy. And the second one focuses on official and unofficial economic activity. It is important to mention from the very beginning that unofficial activity has no relation to classic underground criminal economy. It is something different. An irony is that almost every economic agent is forced to make unofficial economic activity under present conditions in Russia today.

So far there are no commonly used terms to designate the type of an economy, which appears in the transition period from a command economy to a market one. In the Russian economic vocabulary there is a number of terms to name the specific type of an economics in transition. One says "dual economy", "two tiered economy", "mixed economy", "double-strata economy", "two floored economy", "sandwich economy", "dual-track economy", etc.

It is clear that a period of transition from centrally planned economy to market one has

lasted for years. It means that we deal with some new kind of economic system. The characteristic feature of the system is a co-existence and interrelation of the two different mechanisms: command(or centrally planned) and market. There is a sizable literature devoted to the issue[see, for instance, Kuboniwa(1989)]. This literature shows the following main point of the CPE. There is a contradiction between mechanism of commands from one centre and a free will of many individuals. The first one pushes the economy to a single company and the second mechanism leads to voluntary coalitions of independent actors. The contradiction does not occur in the economy of Robinson Crusoe but it does in the real economies.

There is another facet of the issue-individual and collective values embodied within us[Rowles(1971)]. It leads also to dual or mixed mechanisms in economics.

Traditional Soviet studies of the CPE focused on planning procedures, considering an economy as a one big factory. Nevertheless there were attempts to incorporate market mechanism into CPE models. The classic example here is a model with queues and black market[see, for example, Stahl and Alexeev(1985)]. Dual price system occurs naturally here: rigid state prices and shadow prices which are equal to state prices plus length of queue measured in an appropriate way.

The other example gives models of the centrally planned economy with underground economy[see, for example, Pogodzinski, Antes(1992)]. So one has a two tiered economy with two sectors-legal and illegal.

These two examples show us the nature of mixture in the economics. So CPE and market oriented economy (ME) are mixed economies both. There is no pure economy in reality. It can be in theory only. But under certain consideration it is reasonable to think about CPE and ME as "pure" economies,

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economies in stationary conditions, not in transition.

The transition from CPE to ME generates a new kind of mixture. The economy in the transition is dual one by its nature, and a number of questions arise because of that. Some of them are discussed in this paper.

### Two Sectors

A significant feature of the transition period is the coexistence of two sectors within an economy: a state sector and an alternative one. The first sector is based on state property and runs to some extent by a mechanism of commands as in CPE. The second sector can be termed as a private or market sector.

It is necessary to take into account that Russian society at large is broken down onto two parts. Roughly speaking, one part of the society maintains the classic socialist values, dominance of the state property; the other, for free entrepreneurial, private property, etc. And this quite valid fact yields the very clear conclusion: the Russian economy is a special type of a mixed economy, where the command and market systems coexist and relate to each other. The transition to market is going through a rivalry and struggle of the two systems. A smooth path can be achieved if this struggle will be friendly in a certain sense: the transition will be done by many small steps and not one big jump. By the way, "one jump" strategy is popular among some democratic circles in Russia so far. The Chinese economy is very similar to the Russian one in the aspect. A dual-track economic strategy is more smooth than in Russia. The two sector of the Chinese economy exist for more than decade. Statistical data show that both sectors perform well and stability improves their efficiency[see, Chen, Jefferson, and Singh(1992)]. Moreover, the private sector becomes stronger with time. Chen and others write: "During the 1980s China's strategy for a dual-track economy with the state sector's share gradually declining in favour of alternative ownership forms, including private and cooperative owned enterprise has yielded striking success."

In Russia the situation is different completely. The state sector is deteriorating for last three years. The private one is growing

rapidly mainly following federal program of privatisation. But there are no reliable data about private sector performance, its efficiency in particular.

According to the information of Minister of Economics of Russian Federation, Mr. A. Shokhin[Shokhin(1994)] the workforce in the non-state sector consists of 30 mln and its production is 40% of total production at the end of year 1993. The data are consistent with the same number-40%, indicated by Mayor of the City of Moscow Mr. Luzhkov, for Moscow. Russian statistical agency(Roscomstat) did not give accurate indicators of the private sector performance. I show the data here, which indicate in an indirect way that the efficiency of the private sector is better off.

Shares of profit of the state sector vs private sector

	1992	1993(I-VI)	1993(I-IX)	1993
State	71%	69%	52%	49%
Private	29%	31%	48%	51%

This is the distribution of profit excluding profit of the agricultural sector.

### Two Processes of Splitting the Economy

I indicate here the two very different reasons of splitting the Russian economy by its nature. The first one is common for all countries in transition. It is useful to list the specific forms(legal status) of enterprises:

(1) conventional state sector, which includes state owned enterprises, run by managers appointed by the central organs-a ministry or the government itself.

(2a) enterprises on lease. It means that the employees of an enterprise leased the stock and took responsibility for all kinds of activities of the enterprise including supply of materials and selling of production to the consumers.

(2b) stock holding companies with 100% share by the state. This is a new form of the process of denationalization in comparison with(2a), which is old one. The form(2a) was in practice in years 1989-90, when stock holding company's form was permitted only for joint ventures with foreign companies.

(3) stock holding companies, where the



state has less than 100% of shares. Here (3a) stock holding companies with public shares and (3b) stock holding companies with no public shares.

(4) private firms. Russian legislation system, which was established very recently, (see The Law on Enterprises (1990)), allowed a number of forms for private and share holding firms. And the process of improving the system is far from the end. It is important to underline once more that the only conventional state sector belongs to the first strata. All other forms of enterprises consist of the second strata, including stock holding companies with 100% share by state. So it makes a big difference between standard market economy and an economy in transition. Both have a state sector but only the economy in transition consists of the state sector driven by command mechanism.

January 1, 1994, the law on bankruptcy (see, The Law on Bankruptcy), went into operation, at last. In accordance with the law the enterprises of the alternative sector can be declared bankrupt only. An enterprise in the state sector operates under responsibility of central organ: ministry of government directly. So, the government takes care of its financial problems.

I would like to mention that the traditional "socialistic" state areas such as education, science, medical care, are also in the process of the splitting. Russia has now private or semi-private schools, universities, scientific institutes, hospitals. Special law on education was passed recently (see, The Law of Russian Federation "On Education"), where the article 39, section 8 states that non-state educational institution can be declared bankrupt as any other institution which does not belong to the state sector.

Now the second reason for splitting the economy is very different from the first one.

Let me explain it in the following way. In Russia today construction of private houses is flourishing, in the countryside in particular. The reason is that in construction it is easy to run the business without official registration of a firm. The benefit is obvious: a customer pays to a non-official construction firm 1 mln. rubl. in cash, let us say. The whole amount of money is going into construction (materials, wages). All money transfers are instant. If a

firm is officially registered, it must pay 23% value added tax + 32% profit tax + 39% social security tax and +12%, at least, individual tax. The total  $23+32+39+12=106\%$ . And all money transfers are going through a bank with a sizable lag (sometimes several months).

And in addition an economic freedom to run private business was accompanied by numerous rules permanently institutionalizing the sizable federal and local bureaucracy. For example, to register a business as a legal entity it is necessary to get about 12-15 signatures from different governmental bodies.

The following three factors play a key role in creating and driving cash economy in Russia today. First there is a significant gap between speed of functioning of the banking system and inflation. High inflation rate demands extremely fast money transfers. The longer money is in banking system, the greater losses of customers and the greater profits of banks. The only way under the conditions of an obsolete banking technology at large is cash transfers to make quick deals. The second factor is interenterprise arrears. The total amount of interenterprise arrears at the end of year 1993 is equal to 17 trillions rubl., i. e., about one third of GDP. An enterprise is forced to make side payments in cash to be supplied with a production input. The third factor is a standard one: to avoid taxes. But it is necessary to take into account that taxes in Russia today are among the highest in the world. For many businesses the only way to survive is not to pay all taxes.

This is why the present Russian economy is a cash one by its nature to a significant extent.

There are a number of figures, coming from experts, related to the estimation of the share of actual taxes collected in Russia today to the maximal amount of tax. The numbers ranged from 30% to 75%. In the recent report Economics Minister of Russian Federation, Mr. Shokhin says about 65-70% of normative tax collection [see, Shokhin (1994)].

### Two Systems of Prices

The existence of two systems of prices is an inevitable and significant consequence of

the dual economy. Co-existence of the relatively stable state prices and flexible market prices is a very interesting phenomenon, which deserves the attention of theoretical economists. There are two prices, low state price and high market price for the same good, the same place, the same time. How it can happen? Classical example is queuing. The difference between state price and market one is equal exactly to the value of time of search and staying on line[Stahl, Alexeev (1985)]. But in the CPE we have a very developed, sophisticated system of rationing which allows use of the two systems of prices without queues. First of all, well known now is the system of privileges in the former Soviet hierarchy. The second is closed supply systems in large companies, ministries, companies' cities. As usual a large company had its own consumer supply system, hotels, hospitals, resort areas, summer houses, etc. A lot of people engaged in the managing of the access to the mentioned facilities.

What was going on, when alternative ("market") sector started to form itself, but official prices be continued to be set by the state? In the year 1987 so-called cooperatives were allowed to establish (The Decree on Cooperatives(1987)) and almost at the same time joint ventures with foreign companies one can could be organized(see, The Decree on Joint Ventures(1987)). It was the starting point in the process of legalising the alternative sector. There were two significant outcomes of the new situation in the Soviet economy. First is the final recognition and formatting of the two-prices system. And the second is the diffusion of the natural process of the liberalization of income formation to the state sector. Let me make some remarks on both mentioned outcomes.

Sometimes one thinks that the second (high) price for the good is illegal. It occurs in an underground economy as a result of overall deficit. In reality during the whole period of Soviet economy's existence there were so called kolhkoz market prices. The prices are absolutely legal. And the difference between state prices and kolhkoz market prices might be in time. It is impossible to explain the difference by standard economic reasons only, for example by higher quality, better service, availability to make a choice, etc.

for kolhkoz market products. It is some form of the legalization of underground activity as well. When private economic activity in the form of the cooperatives was allowed by the state, free market prices appeared by definition. This is part of the economic freedom for cooperatives to own its products and hence to set price to sell the products. So after cooperative movement started to develop, the two systems of prices became more and more common in the Soviet economy. The market prices captured new areas, partly, intermediate(not for final consumption) goods and wholesale trade.

The other outcome is related to a liberalization of income formation in all the sectors of the economy. It is clear that in cooperatives and further in private firms the levels of wages are determined by themselves. There is no direct regulation of the level by the state. The state tried to control wages in cooperatives indirectly by taxes. Immediately sizable gap between wages in cooperatives and state enterprises appeared. The response of the state sector was done in two directions. The first one was evident: to take over from the central organs more rights to set the level of wages. And the other way was not so evident: I call it a diffusion of the market sector into the state one. The diffusion proceeds in the following form. Cooperatives started to be established within state enterprises, and, as a rule, large ones. The cooperatives use the enterprise's space, equipment, labour force, and produce related goods. Naturally, the wages in the cooperatives were higher than in the enterprise. There was and there is some rivalry between workers of the cooperatives-satellites and the enterprise-parent. The result of the described phenomenon was the introduction of a more flexible system of wage formation in state enterprises.

### Speculation

The word "speculation" is used very often by mass media. This is a standard word in the Russian vocabulary. It means reselling activity, where someone buys a good at a state price and resells it at a market price. It is natural and absolutely legal in a market economy. Moreover, this is the standard way of (equilibrium) market price adjustment.



However, in a centrally planned (command) economy the situation is completely different. All prices are set by the state. Market prices (which appeared in the underground economy) are illegal. So, speculation is strongly forbidden in a command economy. It is natural as well.

Now what happens when market prices become legal? And moreover, there are two sectors, two systems of prices absolutely officially. It is easy to predict that the speculation will flourish. And it occurred actually at that period. Unfortunately, there are no official statistical data about the scale and fields of the speculation activity. It was still illegal. But for the state organs (police, court, etc.) it was impossible to control the situation. They tried to regulate some specific arrears of the speculation activity. For example, cooperatives were forbidden to buy raw materials from state enterprises at a state price. Nevertheless, it was common practice to do it. Millions of people have benefited from the activity, and it was absolutely impossible to stop it by the power of the legal system. But at the same time the state can not allow the speculation because of a mentality of population whose attitude to the activity was and is strongly negative. It was natural political constraint.

So the only way is to destroy two price system as a base of the speculation. Remember that the type of speculation is unfair, ineffective from an economic point of view, and it creates a new generation of people with a poor moral principles, low ethic mentality, and so on.

There are several ways to eliminate the two price system. We are talking about short-run measures. It is clear that in the long-run perspective the conventional state sector shrinks to zero and the base for the dual system disappears. I say "clear", because the dual economy is considered to be efficient only for the transition period to a market and not as a stable form of an economic system at all.

The first way I advocated and wrote [Makarov (1990)] is a little bit complicated technically. It is an introduction of a specific (specially designed) parallel currency for serving the state sector and people related to the sector. So, the two systems of prices stay, but

a barrier is established between them which makes the speculation nonsense. The parallel currency is not at all a standard one. It is something between a currency and coupons. It protects the population of the state sector and people with fixed income from inflation.

The second way was implemented by Russian leaders from the January 2, 1992. It is a liberalization of prices, as we call it.

### **Liberalization of Prices**

First of all it is necessary to be accurate in definition of the liberalization of prices. One can distinguish here the two different processes:

- (1) eliminating any or some restrictions on the prices for certain goods independently of who is a producer or an owner of the goods;
- (2) allowing the enterprises of the conventional state sector to set prices on its products. The last is providing the state sector more economic freedom, but not more to all sectors.

To be understandable, let me give a couple of examples. The Russian government set free the prices on all kinds of meat. The act impacted the state producers only, because private producers sell products at market prices with no restrictions in accordance with the law on enterprise. Formally speaking, the market for meat is not strongly monopolized and the mentioned measure of freeing the state prices on meat seems to destroy the two price system for the market. It is important to emphasise that sizable alternative sector of the meat producers existed before the liberalization and the state sector here is one of the many other producers. One can eliminate the two price system by privatizing all state producers of meat with no formal act of liberalization of meat prices. It will happen automatically. Of course, to privatize the whole industry is impossible overnight, compared to the liberalization act on January 2, 1992.

The other example is related to the crude oil market. Now only the state sector produces crude oil. The government allows oil producers to sell about 30% of their oil at free market prices. One can use commodity exchange for the purpose. So, this is the classical case of the two price system within the state sector. And an interesting thing is

that the state enterprises (producers of oil) behave independently, each for its own benefit, on the free oil market. They become competitors, although they belong to the state sector controlled by the centre-ministry of energy.

I would like to say by these two examples that the process of the liberalization of prices has two sides: one is the interrelation of the state and market sectors, and the other is interrelations within the state sector.

The actual process of the liberalization of prices for the first half of this year revealed a number of inconsistencies and contradictions in relations between state enterprises which are hierarchical in structure. One could see it in retail trade enterprises. The act of January 2 pushed the shops into a shock. Nobody knew how to set prices in the conditions of the freedom. The shops appealed to the higher level of hierarchy—the so-called trusts (unions of shops, storages and other retail infrastructure). The trusts are monopolists and their order was to set prices on the highest possible level. The demand of population went down sharply. And the institutional result of the starting period of the liberalization was the massive complaints by the shops about the trust policy and calls for independence from them. After that the central government and local governments decided to give the retail shops the status of legal entity. The shops opened accounts in banks and obtained the possibility to provide relatively independent policy. Unfortunately, now one can observe the opposite process of strengthening of dependency on shops by the trusts. The fact of the matter is that because the trusts are monopolists, they control supply system of shops completely. It seems that retail trade is a strongly monopolized industry in Russia now. Hence there are the conditions for keeping the two price system. For the incentives to preserve the two price system, see below.

### Allowing the Speculation

After the liberalization of prices the next logical step is to legalize the speculation activity. It has been done by the Decree of the President. The immediate impact was a flourishing of a retail trade on the streets. It seems that all population came out to the streets to

sell something. Criminal situation sharpened, quantity of low quality goods began to dominate. There were massive poisoning of people because of low quality, home made or unfresh food products. All sanitary conditions on the streets were violated. Now the local governments try to control the situation on the streets, to make more or less normal order. But the genie of personal economic freedom is released from the bottle. The problem is to guide the force in a right direction.

During the period of the two price systems existence and especially the last year, a sizable class of people was formed, whose activity is this "speculation". The income in the sphere is much greater then in production, for example, and requires less effort to get it. Easy or crazy earning, people say. The bad thing is that it shifts the human, including moral, values and creates wrong concepts of what is fair and what is unfair. There are stories in our newspapers, where a school teacher as a failor on a street gets in one day more money than her monthly teacher's salary. The same thing is with military officers, scientists, doctors and so on.

It is clear that the situation is temporary, the process of adjustment and creating of standard market structures has its end. But it is evident that there are forces which want to keep the existing position, based on the two price system. The speculation generates huge incomes only under two prices for one good. It is as hard work (as any other) to get money in trade in a standard market economy.

### Incentives to Keep the Two Price System

Let us ask ourselves who benefits from the two price system? Generally speaking these are people who have access to goods at state prices and who have opportunity to sell at market prices. Before the liberalization act a state enterprise had to sell its product at a state price if it is not extra state order production. A state shop must sell the product to people at a state price also. To violate the rule is easier in trade part of the chain. So the trade people have a better opportunity for speculation. As a rule the core of mafia structures lie in the trade sphere. Industrial people and government bureaucrats (related to the setting of state orders) are less involved in the activity. These mafia groups, where trade



people play leading role, try to keep the technology of its business, based on the two price system, after the liberalization act. First of all they keep monopoly situation and prevent the entrance of other suppliers into market. Of course, it is not possible in all markets. It is difficult, say to create two prices for tickets to Metro transportation (subway) because of technical reasons, and easy to do with gas. Today one can see the two prices on gas. The first price is official one, set by government and the other is monopoly price set by mafia which controls the market gas in Moscow and some other cities. There is the same situation in beverage of markets, and many other consumer goods. I think that the situation here is temporary. The standard antimonopoly measures seem to be effective in breaking the two price system in the sphere.

A much more complicated and long run situation occurs in capital markets. The market of capital goods: financial markets, real estate, capital stock markets, etc... are in the very initial phase now in Russia. At the same time the program of privatization was declared by the government recently [program]. We have the process of massive privatization. So, big money started to move from trade to capital market. I say "big money", because the two price system in the market is a reality here. There are no effective ways to eliminate it quickly. One can become a millionaire overnight, literally. There are such examples yet. A colonel, who was in charge of running a military tourist camp in a luxury resort Black Sea area, bought the hunting house of Nikolas the Second-the last Russian tsar. The official state price was 25 thousand rubles, set by the Ministry of Defence, the owner of the house. The colonel, who runs the house, prepared all accounting books with necessary valuations based on year 1973 prices. Now 25,000 rubles is the prices of one day stay in the ordinary hotel in the area. Real market price of the house is half a billion rubles by a rough estimation.

Privatization in Moscow is finished in the sectors of retail trade, services, transport, construction, speaking in practical terms. From the point of view of economic efficiency, Mr. Luzhkov states that the pres-

ent way of privatization gains ownership of a property and not production efficiency. Having property, one can convert it into money or any other assets.

Another very fresh example was reported by Mr. Luzhkov, Mayor of the City of Moscow [Luzhkov (1994)]. The book value (formal nominal price) of Luxury Five Stars Slavianskaya Hotel in Moscow is equal to 200 mln Ruble or about \$125000. This is the hotel where President Clinton stayed during his visit to Moscow in January 1994. Mr. Luzhkov said that there are serious attempts to privatise (to buy) the hotel at that price.

The interesting thing, which may make clearer the incentives to keep dual price system, is contained in the Federal program of privatization. It has a special point to make clear the issue that state prices, for the privatization of real capital is evaluated in the prices of year 1991.

Mr. Luzhkov mentioned as well that the Federal Government tax and fiscal policy strengthens the disintegration process, pushing regions to provide their own tax and privatization policy. Moscow Government, has strong intention to do so. For example, the Federal Government reduces taxes for certain sectors and enterprises, shrinking the amount of money going to a regional budget. It is a very important point in the whole issue of the privatization. The power of central and local government's bureaucrats in the choice of privatization object is dominant. They have the key parameter to control the situation. They need to keep the two price system to benefit from their power!

There are ways to control market prices too. It is enough to limit a number of the trade participants, to close the information about the object of trade, and so on, and the market price will change.

### **The Way to Eliminate the Two Price System**

The dual economy and, partly, the two price system is an inevitable phenomenon in the process of transition of CPE to a market. One understands also the impossibility to substitute state prices with market ones overnight. The market prices can serve as a guideline for changing state prices. There are several logically possible ways to eliminate

the two price system. Let me enumerate in order of consistency to the reality of the Russian economy.

1. Overall liberalization of prices, where practically all prices are free, state enterprises are allowed to set prices as their own responsibility, including strong monopolists. This way is a little bit chaotic, but it relates to the present Russian reality, because the control of the central government is actually weak. There is a significant shift of power from the central government to the local governments. In this situation it is difficult to control the use of stable state prices in deals. Very high monopoly prices are the most dangerous impact of this way, creating the conditions for a hyperinflation.

2. The state prices are state prices. It means that until the conventional state sector exists, the prices on its production are under control of the state as the owner of the sector. It is essential especially for the military sector and its conversion to the civilian one. Then the two price system will disappear together with the disappearance of the conventional state sector. Here the privatization and "de-statization" are important. The Quicker privatization, the earlier elimination of the two price system. This way takes more time than the first way. The way is natural when the central government has enough power to control the state prices, to collect federal taxes and to subsidise in a relatively efficient way the state sector's industries.

3. Convergence of the state prices to market ones. This way requires more power from the central government than the second way. Needless to say, state prices are less flexible than market ones. But it is flexible in a sense, that government agencies can change the prices in the direction indicated by market, in a relatively short interval of time. It makes sense especially for goods like oil, gas, wheat, and other key mass products. The regular changes of the prices by the state can be done technically in the form of recalculating the old prices to economize price-current book printing, or in changing the key prices only. It seems that this way generates the stability and the better control of inflation in the economy. Computer simulations show the great instability, and large probability of chaotic development in the situation where

overall liberalization of prices is implied within a short period of time of much more stable development. One can observe if the state prices converge to market ones gradually, not at one jump. At the same time the other processes take place: diminishing of government subsidies, privatization, liberalization of foreign trade and so on.

4. Introduction of a parallel currency for the state sector. Then the state prices are at one currency and market one at another. This is genuinely a dual economy. The two sectors use different currencies, different economic mechanisms, incentives, different ideology and understanding of fairness. The responsibility of the state is to provide the fair conditions for competition of the sectors. People must have a choice: to go to the first sector with stable, relatively poor life under high security of the state, or to go to the second sector with better opportunities to apply their personal abilities, more economic freedom for business, less (economic) security provided by the state, more uncertainty and so on. In a long run perspective a kind of equilibrium is achieved, where the size of a state sector is natural for the given society with its cultural, historical, religious, national traditions. When the transition period to that time is over, there is no necessity, to have the other currency any more. The protection of the people with stable income can be achieved by the standard methods.

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