

THE STATE AND AN INVESTMENT-CENTERED ANALYSIS

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The basic assumptions of self-interested economic behavior illuminate why large investment is so problematic. There is no activity in modern industrial society that rests to such an extent on trust in such a range of actors. Depositors must feel confident in putting their money in impersonal banks; banks must think that borrowers whom they do not know will not disappear; companies must be able to issue stock in whose general honesty investors can believe; entrepreneurs must trust contractors to do reliable construction work, and they must assume that their project and its fruits will not be stolen when the project is finished. Investors know they may make a bad investment decision with respect to future market demand, but at least they want the assurance that a stable market will exist at that time. Neoliberal economists even insist that investors must have assurances about rates of inflation.

In modern society, much is done on implicit trust, but abstract trust is not enough even in modern society. Even in the United States today, people demand a government guarantee on their bank deposits, and business personnel demand legal guarantees against fraud at all stages. When a savings and loan crisis occurs or a hedge fund makes very bad decisions, the government is expected to intervene in extraordinary ways. Even when no crisis occurs, a *New York Times* reporter could note in 1999 that “judging from the cases streaming out of

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prosecutors’ offices recently, it seems as if securities fraud rivals the internet as the nation’s hottest growth industry.”¹

But in earlier stages of industrial development, trust in unknown persons and impersonal organizations is far more fragile at every link of the chain. Paradoxically this point was never made more eloquently than in the case of Russia, but the Russia of the 1890s and 1900s by Alexander Gerschenkron, a great Russian emigre economist who taught at Columbia and Harvard universities in the 1940s and 1950s.

Most of the conditions and problems Gerschenkron described in Russia of the 1890s seem similar to those in the 1990s, but not the role of government. Gerschenkron noted the importance of “the great judicial and administrative reforms” of the 1860s for “creating a suitable framework for industrial development.” Yet, he strongly emphasized that “the main point of interest [in Russia of the 19th century] is that, unlike the case of Western Europe, [the creation of a well-functioning legal system] did not per se lead to an upsurge of individual activities in the country.”² By contrast, although the legal reforms of the 1990s were less thorough than those of the 1860s, the reformers of the 1990s assumed they would work automatically.

According to Gerschenkron, the reason that legal reform alone was insufficient in Russia in the 19th century was that conditions did not exist for the creation of the requisite banking system that could support investment:

The scarcity of capital in Russia was such that no banking system could conceivably succeed in attracting sufficient funds

¹ Gretchen Morgenson, “On the Seamier Side of the Bull Market,” *The New York Times*, July 11, 1999, III, p. 1.

² These statements and those that follow come from Alexander Gerschenkron, *Economic Backwardness in Historical Perspective: A Book of Essays* (Cambridge: Harvard University Press, 1962), pp. 19–22.

to finance a large industrialization; the standards of honesty in business were so disastrously low, the general distrust of the public so great, that the no bank could have hoped to attract even such small funds as were available, and no bank could have successfully engaged in long-term credit policies in an economy where fraudulent bankruptcy had been almost elevated to the rank of a general business practice.

The difference between the 19th century and the 1990s was that Western economists demanded real bankruptcy in up to 60 percent of the enterprises, thus making loans even more dangerous.

Gerschenkron's conclusion was clear-cut, and the Russian model that he described became the basis for the so-called Asian model of the 20th century:

Supply of capital for the needs of industrialization required the compulsory machinery of the government, which, through its taxation policies, succeeded in directing incomes from consumption to investment. There is no doubt that the government as an *agens movens* of industrialization discharged its role in a far less than perfectly efficient manner. Incompetence and corruption of bureaucracy were great. The amount of waste that accompanied the process was formidable. But, when all is said and done, the great success of the policies pursued under Vyshnegradski and Witte is undeniable.

Indeed, even the high levels of corruption in the early and middle level of capitalist development—e.g., the United States during the “Robber Baron” era or the Pacific Rim countries in recent decades—can play a useful and perhaps indispensable role. At a stage when impersonal financial institutions do not function smoothly or reliably, the personal and corrupt ties between entrepreneurs and government officials are often a substitute—indeed, a substitute that ensures government support for the success of a project.

Whether or not corruption is a necessary substitute for

impersonal financial institutions at a certain stage of capitalist development, the United States of the 19th century and the Pacific Rim countries of the second half of the 20th century conclusively demonstrate at a minimum that corruption is not incompatible with economic growth. But corruption is beneficial for economic growth only if the fruits of corruption are invested in the local economy, and in projects whose success is being sponsored by the government officials who hope to benefit from it.

The problem in Russia was not simply corruption, but the conviction on the part of the corrupt that it was more profitable to receive the low dividends of Swiss bank account than the potential large profits of an emerging market where they had special information and special protection from government officials. The reform failed not because of the corruption, but because of the conditions that convinced the corrupt and the non-corrupt alike that the cost-benefit ratio in Russia was not favorable for investment.

Modern neoliberal economists fear that a government assuming such a strong directing role, often tainted by corruption, will not relinquish it, but Gerschenkron pointed out that the role of government naturally changed in Russia after 1890. By the 1907 to 1914 period the direct role of the state was “very greatly reduced,” as the conditions for private investment were being created.

The retrenchment of government activities led not to stagnation but to a continuation of industrial growth. Russian industry had reached a stage where it could throw away the crutches of government support and begin to walk independently—and, yet, very much less independently than industry in contemporaneous Germany, for at least to some extent the role of the retreating government was taken over by the banks . . . As industrial development proceeded apace

and as capital accumulation increased, the standards of business behavior were growingly Westernized. The paralyzing atmosphere of distrust began to vanish, and the foundation was laid for the emergence of a different type of bank . . . In short, after the economic backwardness of Russia had been reduced by state-sponsored industrialization processes, use of a different instrument of industrialization, suitable to the new “stage of backwardness,” became applicable.

Gerschenkron used the word “industrialization,” but, of course, he meant “market industrialization” and hence his words were as applicable to the marketization of the 1990s as to the industrial development of the 1890s. One of the great mysteries of Russian economic reform is that virtually none of the reformers or politicians looked back to the economic model of the Russian industrialization drive of Nikolai II that Gerschenkron described. The early Gorbachev reformers hailed the experience of Lenin’s New Economic Policy in the 1920s, often for tactical political reasons, but even as Russian interest (and often praise) of Nikolai II reemerged, almost no one focussed on his successful economic policy.

As we examine the history of economic reform in Russia in the 1990s in this book, we will, therefore, see that the problem was not simply a weak state or a lack of institutions. Russia had a strong state and ample institutional rules. The Russian state and the international organizations created a powerful set of incentives (that is, real institutions), and the logic of those incentives led normal economic men to the behavior that is rightly deplored.

What economic reform in Russia lacked was a government (and international economic organizations) with an awareness that the incentives for investment had to be carefully structured, that trust was based on legal restraints, and that government is required to compensate as that trust is be-

ing built. Investors needed assurance on far more questions than inflation alone. As this book describes the state actions and the incentive system they created, it will hopefully point to other actions and incentive systems that will help correct the situation.

THE DEBATE OVER THE CHARACTER OF PRIVATIZATION

As Peter Murrell emphasized, there is a major difference between the concepts of “privatization” and “creation of a private sector.” Privatization is not the only way of creating private property, and privatization will not be succeed without the creation of new private property. Both practically and theoretically, there is much to recommend the Chinese model of privatization: the government does not privatize large-scale enterprises, especially in the raw materials industries that naturally would provide instant unearned wealth. Individuals or companies are allowed to create new private firms, but land is not sold to individuals, only leased. The state then privatizes its own property in a gradual, orderly manner, beginning with trade and small enterprises that are the easiest to privatize. The government thereby creates incentives for those still working in the state sector to continue to produce, and those seeking the wealth associated with private production or trade are driven to create their own enterprises and therefore contribute to economic prosperity.

The striking thing about the Soviet Union in the last years of Gorbachev’s rule is that economic reformers thought little about the creation of new private property such as occurred in China, but took privatization for granted. The issue of how and what to privatize was, however, highly controversial, and many of the issues remained hidden beneath the surface. Thus, the debate on the free sale of land had little to do with agricultural reform, but primarily involved the right

of urban individuals to buy urban land or, perhaps, rural land for non-agricultural use. Similarly, reformers saw the privatization of large enterprises that could not survive without subsidies as a way of forcing them to close or reduce labor force drastically. These hidden issues were politically sensitive and therefore seldom fully discussed in public.

The open debates focussed on the method of privatization. The gradual reformers associated with Premier Ryzhkov who focussed on investment and savings as the way to absorb excess purchasing power naturally wanted to sell property rather than give it away. Most wrote about small scale privatization of property that small investors would find safe and familiar—e.g., privatization of apartments on the basis of long-term mortgage loans, shops, and so forth. This, however, was not always the issue.

In 1991, Premier Valentin Pavlov insisted that the economic enterprises administered by the USSR ministries were USSR property and their privatization solely the prerogative of the USSR government acting through its Fund of State Property. Pavlov intended to privatize property by selling it on a ten-year time payment program, usually to its own workers, but sometimes to foreigners or other Soviet individuals who might buy it. He expected to receive 200 billion rubles within a year or year and a half and 350–400 billion rubles in three years.³ Those were huge sums at the time.

The issue of who controlled privatization was the central one in the break-up of the Soviet Union. If the USSR owned all “its” property until it was sold, and at least retained final title for 10 years while payments were being made, it held the economic base of the republics in its hands for a long time. But if the republics owned the property, they logically deserved its fruits immediately. On this basis, Yeltsin

³ *Komsomol'skaia pravda*, July 5, 1991, p. 1.

as President of the Russian Republic claimed all the foreign and domestic earnings from the oil and natural gas fields on Russia's soil, as well as the taxes and proceeds from the large plants.

Yeltsin's claim to all economic enterprises on Russian soil meant that the USSR would have no financial base, not even that needed to repay foreign loans, and no meaningful economic role. Gorbachev inexplicably failed to resist Yeltsin, and the entire government conducted the August 1991 coup in a desperate effort to save the Soviet Union.⁴ But when the coup failed and Gorbachev continued not to resist republican claims to industrial property, the question of USSR ownership was decided by default.

When the republics gained control of property, they might well have adopted Pavlov's proposed method of privatization and sold property on time-payments at a reasonable market value. Indeed, foreigners generally favored the sale of state assets as a method of privatization.⁵ This method would help absorb any excess monetary supply, at least so long as inflation did not wipe out the real value of future payments. Unfortunately, only insider managers, foreigners, and those in the illegal second economy had the resources to acquire property outright, and this was not attractive to Yeltsin's main constituencies.

The instinctive Marxist solution to privatization, if it were to be done, was to give it to the workers who were employed in an enterprise and then to institute some kind of workers' self-management. The concept of collective prop-

⁴ See the discussion in Jerry F. Hough, *Democratization and Revolution in the USSR, 1985–1991* (Washington: Brookings Institution, 1997), pp. 422–443.

⁵ Maxim Boycko, Andrei Shleifer, and Robert Vishny, *Privatizing Russia* (Cambridge, Mass.: The MIT Press, 1995), pp. 11–12.

erty or even the Saratov model of stock ownership found in the Gorbachev period basically embodied this type of privatization.

Nevertheless, the solution of employee ownership had major flaws. First, if employees were to acquire property at little or no cost, the result would be very inequitable. Workers of the oil industry would become rich, those of textile plants would receive relatively little of value, and teachers and librarians would receive nothing. The disastrous shortcoming of this model from a political point of view was that the radical intellectuals who had provided Yeltsin's core support were almost all employed in institutions whose employees would not benefit.

Second, in the real world, power in employee-owned enterprises would almost surely devolve to top management. Even if they did not sell off assets to friends and relatives, many feared that inside managers might not be the most innovative. Soviet managers had been production engineers judged only by output indicators, and they might not make the transition to the efficient production of consumer-oriented goods. The notion that these plant managers might be retained as assembly plant managers in large corporations was not part of the debate.

The major alternative to employee privatization was the issuing of vouchers to the broad population on a free or virtually free basis and allowing the recipients either to use them to acquire property or to sell them to others. But even here a variety of plans were possible. Citizens could be offered shares in mutual funds or else they could use the vouchers themselves to buy shares in mutual funds or enterprises. The latter program in turn had two major variants, one in which the recipients did not have the right to transfer their shares for a number of years and the other in which they were free

to sell their vouchers or give them away immediately.

There were two major arguments for distributing property to the population free or basically free through a voucher system, but, unfortunately, the arguments were inconsistent with each other. The first—and naturally that most frequently used in public—emphasized equity and political factors. Everyone would be treated equally regardless of where they worked; everyone would become a shareowning capitalist (Yeltsin was lyrical on this point in August 1992). With everyone gaining from privatization, this should build widespread political support for privatization. In fact, our December 1993 survey near the end of the voucher process found support for privatization of large-scale enterprises evenly divided, a much more favorable result than in the past or than it was to be in the future.

The second argument for voucher privatization was proclaimed less loudly because it was politically less appealing. The reformers fully expected for the vouchers to flow into the hands of those with financial skills and resources either through their own purchase of vouchers or through the creation of mutual funds. This would create a group of powerful outsiders with financial and economic expertise who could challenge the insiders for control of the large enterprises. Neither the economists in the international economic community nor the young economists associated with Yegor Gaidar doubted the superior ability of those with economic expertise.

The first problem with the argument about restructuring was practical, as Stanley Fischer, soon to be deputy head of the IMF, made quite clear in 1993:⁶

⁶ Stanley Fischer, in "Comments and Discussion," *Brookings Papers on Economic Activity*, no. 2, 1993, pp. 182–183.

The key question . . . is whether privatization will lead to restructuring . . . [It is argued] that privatization is the one reform that brings immediate benefits to consumers and voters. This is true of the first stage of the process, when vouchers are distributed and consumers are given ownership of firms. However, it is not true at the restructuring stage, when unemployment is likely to grow—and that may help explain why restructuring has been so slow.

“Restructuring” was, in fact, a euphemism for downsizing the labor force and reducing unproductive social expenditures. Indeed, Lawrence Summers suggested that as many as 60 percent of the enterprises would have to become bankrupt.⁷

If the mutual funds or other financial groups began to reduce the number of workers, close down factory social service institutions, and so forth, workers being replaced were not likely to see privatization as an unmitigated good.

But, besides practical political objections, major theoretical questions need to be raised about the arguments in favor of the voucher privatization. The core argument for vouchers came, first of all, from the analysis of Friedrich von Hayek:⁸

A “neo-Austrian” economist following the philosophy of Friedrich von Hayek would advocate the immediate marketisation of virtually all state assets. Of course the neo-Austrian would concede that this could result in speculation and incumbent abuse on a large scale, especially in the short term, but would insist that such speculation is at the very heart of the capitalist system . . . The profits and losses of successful and unsuccessful entrepreneurs are the signals that lead others to compete and follow . . . On this view it is irrelevant

⁷ Summers—60 percent privatization.

⁸ Filatotchev et al, “Privatisation and Buy-outs in the USSR,” pp. 279–280.

whether those who profit are foreigners, criminals or communists, so long as the signals are observable, thus making competition inevitable.

Chubais himself reports that reading Hayek had an enormous impact upon him as a young man,⁹ and he was quite cavalier about the criminal background of those who would buy trade and service firms. “We are taking into account the demand from representatives of the ‘second economy,’” Chubais told the press in January 1992.¹⁰ Former deputy premier Leonid Abalkin reported that Anatoly Chubais had made a similar argument privately:¹¹

[He] said that the task is to create a modest number of real owners. Chubais realized that the owners will mostly be criminally oriented people. But, he said, there are no others . . . And without real entrepreneurs and owners, Russia will never get out of the hole.

The argument made by the reformers in the United States did not refer not to Hayek, but to Coase’s Theorem, an important part of the American literature on property rights. The theorem was actually named for Coase by George Stigler based on ideas that Coase had presented less formally, and it has been summarized in the following terms:¹²

⁹ *Economist*. Quoted and discussed in Hilary Beth Appel, “Mass Privatization in Post-Communist States: Ideas, Interests, and Economic Regime Change (Economic Reform, Russia, Czech Republic, Property Rights), p. AAG9829855.

¹⁰ “Gosudarstvo idet s molotka,” *Moskovskie novosti*, January 12, 1992, p. 14. Quoted in Lynn D. Nelson and Irina Y. Kuzes, *Radical Reform in Yeltsin’s Russia: Political, Economic, and Social Dimension*, p. 46.

¹¹ Quoted in Nelson and Kuzes, *Radical Reform in Yeltsin’s Russia*, p. 53–54.

¹² William Mitchell and Michael Munger, “Economic Models of Interest Groups: An Introductory Survey,” *American Journal of Political Science*,

If (a) property rights are well-defined, (b) transactions costs are trivial, and (c) wealth effects can be ignored, *then* externalities are internalized through the self-interested negotiations of the parties involved, resulting in the same allocation of productive resources regardless of who possesses the property rights or liabilities so long as these rights are well specified.

The Coase Theorem argued that if its conditions were satisfied, societal conflicts could always be regulated more efficiently through private contracts than through government intervention. A key implication in the Russian case was said to be that the original owner of the property was immaterial. Control over the property in a market economy inevitably would flow into the hands of the most efficient owners, and government involvement was counterproductive.

If one took the Coase Theorem seriously, however, it was quite conditional. Robert Inman and Daniel Rubinfeld, for example, are explicit about the meaning of “transactions costs are trivial.” They include “there are no resource costs associated with reaching agreement,” “all bargaining agreements are costlessly enforceable,” “preferences over bargaining outcomes and the resources of participants are common knowledge,” and “bargaining agents perfectly represent the economic interests of their constituents.”¹³

Critics of the Coase Theorem insist that its applicability in the United States is severely limited because negotiation costs are always impossibly high when millions of people have to negotiate, say, environmental restrictions. They note that

vol. 35, no. 2 (May 1991), p. 532. The italics are in the original. George J. Stigler, *Memoirs of an Unregulated Economist* (New York: Basic Books, 1988), pp. 73–80.

¹³ Robert P. Inman and Daniel L. Rubinfeld, “The Political Economy of Federalism,” in Dennis C. Mueller, *Perspectives on Public Choice: A Handbook* (Cambridge: Cambridge University Press, 1997), p. 76.

these collective action problems involved in transaction costs had always been the justification for government and that Coase only documented why government is necessary.

But whatever may be said about the United States, Coase’s conditions clearly were not met in Russia: property rights were not well-defined, bargaining agents had little information and accountability, and the enforcement of agreements was scarcely costless or even reliable. Winston Bush made the basic point a quarter of a century ago: “the neo-classical theory of marginal productivity implicitly assumes a post-constitutional state in which a completely effective and costless enforcement mechanism against theft has been instituted.”¹⁴

Western and Russian neoliberal economists gave little thought to the possible consequences of privatization and free negotiations among individuals when none of Coase’s conditions were met. For this reason, their assumptions were much closer to Hayek’s than to Coase’s, for the Hayek showed little concern about preconditions for a successful market economy other than the non-involvement of the government. Neither did those introducing reform in Russia.

THE RUSSIAN REFORMERS’ ASSUMPTIONS ABOUT INVESTMENT

The neglect of investment during the 1990s in Russia was very peculiar. Olivier Blanchard was right that it seemed obvious that large-scale investment must be a key element in making Russian production more efficient and developing new products. Whatever naive assumptions people may

¹⁴ Winston C. Bush, “The Hobbesian Jungle or Orderly Anarchy,” in Arthur T. Denzau and Robert J. Mackay, *Essays on Unorthodox Economic Strategies: Anarchy, Politics, and Populations* (Blacksburg, Va.: University Publications, 1976), p. 34.

have had in 1989, the enormous investment that West Germany was required to make in East Germany should have illuminated the situation for everyone. Even after a decade, the situation in the former East Germany remained difficult enough for the local voters to turn against Chancellor Kohl and the Christian Democratic Party. Russia had eight times the population of East Germany and presumably required at least eight times as much investment.

In addition, Boris Yeltsin was a construction engineer who had spent two decades in construction management in enterprises and in the Communist Party organs. He then served for ten years as governor (obkom first secretary) of one of the most important heavy and defense industry centers. All of his instincts should have led him to emphasize construction and investment. All of his old friends and associates should have been telling him about the disastrous consequences of his anti-investment policy on the region that he had spent a lifetime building up.

There were many elements in the sequence of events that led to such a profound neglect of investment in Russia in the 1990s. They began with the belief of Mikhail Gorbachev that the population needed to see the benefits of perestroika before suffering its costs and that high consumption must be maintained. Gorbachev and his advisers did not appreciate that an investment program that sustained and increased production protected consumption better than direct support of consumption at the cost of investment. They did not understand that agricultural reform, after a short transition period, was the best way to raise living standards and to free up export earnings for the purchase of capital goods instead of foodstuffs. Yeltsin and his advisers repeated the same mistakes.

Gorbachev and his advisers defended their decision to

maintain consumption at the cost of investment by reference to a long-recognized fact. The Soviet Union historically had a high rate of investment and much of it went to industries and products that were not appropriate for a country at the Soviet Union's stage of development. If non-productive investment were reduced, consumption and even economic growth, it was argued, might be affected only minimally.

Maintaining consumption became even more difficult in 1990. The Politburo was convinced that Soviet Union's terms of trade with Eastern Europe were unfavorable, and it made an extraordinarily ill-advised decision to put trade with Eastern Europe on a hard currency basis. Eastern Europe had little hard currency at the time and the Soviet Union was dependent upon it for a number of key imports. The trade between the two regions, including exports of consumer goods and medicines to the Soviet Union, dropped precipitously. Oil prices were also falling. As a result, the negative balance of trade of the Soviet Union as a whole was \$19.8 billion in 1990. The total Soviet imports fell from \$120.7 billion in 1990 to \$68.2 billion in 1991 to help correct this situation—from \$82.9 billion to \$45.6 billion in Russia alone. The Soviet Union had \$10.9 billion net credits in 1990 and \$12.0 billion in 1991.¹⁵

At the time, the young reform economists associated with Yeltsin became more exposed to neoliberal economics, and they found additional arguments to delay investment. The first was that investment should wait until institutions had changed. Western neoliberal economists had first encountered the problem of investment in the collapse of Communism in Eastern Europe in 1989. Many Westerners called for a new Marshall Plan of investment in those countries,

¹⁵ Stanley Fischer, "Stabilization and Economic Reform in Russia," *Brookings Papers on Economic Activity*, no. 1, 1992, p. 82.

but economists such as Lawrence Summers noted that East-Central Europe already had a fairly high rate of investment. “The problem is that given the amount of capital, growth is relatively slow.” He drew the following conclusion:¹⁶

The answer does not appear to be in simply providing more capital. Rather it seems to require raising the rate of return on the capital investment . . . If growth is to be accelerated, one needs to create a more productive institutional environment in which investment is made more profitable, and not simply provide increasing amounts of capital. It is that institutional gap, and not a capital gap, that needs to be solved if Central Europe is to have a chance of taking off.

The problem in the Soviet Union was more severe than in Eastern Europe, for it had not had the partial market reforms and administered price adjustments that were introduced in northern Eastern Europe after the 1950s. In addition, young Russian academic economists and Westerners without knowledge about the Soviet economy thought the problem even greater than it was. Western industrialists always talked about the high quality of Soviet managers and the high quality of the technology of their advanced plants, but the neoliberal economists had deeply-rooted prejudices about the “nomenklatura” and Soviet technology. For the economists, “de-industrialization” in the usual sense of a decline of the percentage of the population employed in industry often took on the literal meaning of the closing of industrial plants.

If the old enterprises and their managers were hopeless, then large-scale investment should not be devoted to an effort

¹⁶ Lawrence Summers, “The Next Decade in Central and Eastern Europe,” in Christopher Clague and Gordon C. Rauser, eds., *The Emergence of Market Economies in Eastern Europe* (Oxford: Blackwell, 1992), pp. 31–32.

to reconstruct them, especially while they were led by the old managers. Investment should be made by new businessmen or new managers after privatization had occurred. No doubt, the economists believed that the new corporate and financial elite should be drawn from young persons with economic and financial knowledge like themselves. They believed that a reduction in defense expenditures and investment would allow consumption to be maintained at a reasonably high level during a short period of severe pain produced by the shock therapy.

The neoliberal economists understood that investment would eventually be important for economic growth, but they saw it as emerging almost automatically if the proper macroeconomic conditions were created. For this reason, they saw no need to pay special attention to the stimulation of investment in Russia. If property were privatized, prices were freed, and monetary stabilization were achieved, then potential investors would almost inevitably respond.

There were, however, two obvious problems with this argument as it applied to Russia. First, the correct conclusion that capital alone would not solve the Russian economic problem did not change the fact that huge amounts of investment were necessary—and necessary quickly. The creation of more efficient plants and of new products would require new machinery and machine tools. If a product proved successful, there would be need for enormous capital to expand capacity.

This point was made to me in two interviews in 1992. The first was with the chief engineer of the Kharkov Tractor Plant. The plant had long produced large tractors, and Soviet and Western economists had long advised it to produce smaller tractors that peasants could use in smaller fields. Now that economic reform was imminent, the plant should

obviously follow this advice. The chief engineer expressed a desire to do so, but said it was impossible. The plant received its tractor motors from the Yaroslavl Motor Works, and the latter only made motors for large tractors.

Later in the year, the chief engineer of the Yaroslavl Motor Works was asked whether they were beginning to produce smaller tractor motors for the Kharkov Tractor Works. The answer was that such a change would require new assembly lines and new machine tools, and the plant did not have money to buy this equipment. If plant managers were autonomous and thinking in market terms when making “inter-enterprise loans,” as often assumed, the director of the machinery plants could have provided an inter-enterprise loan to the motor plant. This would even been a loan that led to the production of an item with a market and a reduction in the production of an item with a declining market. But, of course, the managers had no autonomy on production questions, and the government was not authorizing “loans” that were associated with new investment.

Indeed, even the service sector required great investment. For example, financial institutions needed to be computerized. In 1993, 90 percent of all transactions between banks, including the Central Bank clearing houses, were done by paper. Five copies were required, the copies almost surely made without help of photocopiers.¹⁷

The computer industry in turn needed to be modernized and expanded. The notion that all the capital goods plants could be destroyed simultaneously and arise from the rubble simultaneously with new and more advanced goods produced by new and more efficient machinery was little short of insane. It was, however, the implicit assumption under-

¹⁷ M. P. Berezina and Iu. S. Krupnov, *Mezhhbankovskie raschety* (Moscow: Finstatinform, 1993), pp. 39 and 42–43.

lying policy, for machinery plants were never supported by inter-enterprise loans and barter arrangements on the scale of other enterprises.

The second problem with the argument that investment should wait for institutional change came in Summers’ phrase “institutional gap.” The word “gap” implied a known set of institutions toward which Russia must move—a set that could be instituted in some kind of package. It implied that the problems to be solved by institutions in the early stages of marketization were the same as those in post-industrial capitalist society. It implied that the same institutions were needed at all stages of development. The belief that investment should be postponed until institutions were ready to use it efficiently was simply another sign of the belief that there was a chasm to an efficient market economy that could be leapt in a single jump.

No neoliberal economist attempted to answer the arguments that Gerschenkron made with respect to Russia in the 19th century. What were to be the banking institutions that were to collect savings and to make loans in conditions of full lack of trust? Why should anyone make a loan to new owners when the top reformers in the Yeltsin regime—and the IMF and Western economists as well—were saying that they were incompetent and corrupt and that their plants would be bankrupted in two or three years when the voucher phase of privatization was finished. It was as if industrial development would arise from scratch as in England in the 18th century except that industrialization could not be based on agriculture as it had in England because no agricultural reform was envisaged.

THE LOGIC OF CRIME AND CORRUPTION

In the absence of reliable statistics, observers naturally disagree on the amount of crime, “mafia” activity, corruption, and capital flight in Russia, but no one doubts that they are quite substantial. The problem is to understand its significance. The neoliberal reformers see the illegalities as exogenous factors that have harmed, if not ruined economic reform. In this view, they are the product of historical factors: the lack of a capitalist culture, a long-ingrained lack of respect for the government, the absence of a well-established legal tradition, and the high levels of corruption in the Communist economic system. As late as September 1999, the US national security adviser, Samuel Berger, was still insisting that “to understand corruption in Russia, we must understand that it is rooted in the legacy of Soviet communism.”¹⁸

The argument is so inconsistent with the basic assumptions of neoliberal economics (or, indeed, of almost any economic theory) that we should be very skeptical. Rather, we need to return to the arguments of the classic neoliberal economists of the past that crime and corruption can be the rational response of economic actors to certain sets of incentives. Obviously individual deviance exists in any society among those who are responding to psychological factors as well as economic incentives, but when crime and corruption become widespread, they are certain to be rational responses to the existing incentive system.

Moreover, mafias and corruption can be supportive of economic performance and growth, at least to some extent. Corrupt people want to invest their money where they can make a maximum return, and this is likely to be where they

¹⁸ Samuel R. Berger, “Getting the New Russia on Its Feet,” *The Washington Post*, September 5, 1999, p. B7.

have government protection. Mafias have an interest in the prosperity of their territories so that they can maximize their own return. The real question about economic reform in Russia is why the corruption and mafia activity that arose in Russia did not have this effect.

THE MAFIA AND INVESTMENT

As has been seen, neoliberal economic theory insists it is more rational for A to steal B’s corn than to trade for it if the two live in an anarchic environment and B is not well-armed.¹⁹

The problem of ensuring that A does not steal B’s corn goes back to the beginnings of civilization. People originally lived a nomadic life as hunters and gatherers. Civilization began when some groups decided to “invest”—to plant and care for plants and to raise animals so that their “hunting” and “gathering” at the end of the season would be easier and more productive. The thought naturally occurred to those who were still nomadic that the fields of the planters and shepherds were the most convenient place to do their own gathering and hunting.

The liberal theory of the origin of the state begins with the need of agricultural peoples to protect themselves and the products of their investment from marauders. One can see the rise of the state in functional terms, but Mancur Olson described the origins of the state with the analogy of a “stationary bandit.” A state of anarchy is populated by a large number of roving bandits, but, in Olson’s view, the leader of one of those bands understood that if he became stationary and monopolized theft in a particular area, he could become wealthier and lead an easier and more respectable life. The

¹⁹ Dennis C. Mueller, *Public Choice II* (Cambridge: Cambridge University Press, 1989), p. 9–10.

wiser stationary bandits understood that if they promoted growth and regularized their theft (now called taxes) by limiting to a fixed, finite percentage, they could maximize their economic return.

In historical perspective, the state provided the basis for the rise of civilization and the increase in economic productivity seen over the last 10,000 years. In any shorter time perspective, however, the state often failed to provide sufficient protection to economic actors. Indeed, the military force that the state accumulated often posed a direct danger to domestic economic actors or an indirect one through the wars in which it engaged and lost.

When the state is too weak to provide adequate police and military protection to economic actors, the latter must provide their own. The essence of feudalism was not only a lord-serf relationship, but also the lord's creation of a military force to protect those in his domain—and, no doubt also to force peasants into it. The large landlords in Haiti with private police or the tribal militia in Africa are not different in principle. A specialist on mafias, Diego Gambetta, defines them as “agencies that supply protection of illegal markets,” but the generalized subtitle of his book on the Sicilian Mafia (“The Business of Private Protection”) is more accurate.²⁰

Even in a modern capitalist society, some spheres of the economy remain without state-provided police and legal protection, and, instead, are the object of police harassment. This was true of gambling, prostitution, and especially the sale of alcohol in the 1920s. The “mafias” and gangs of the

²⁰ Diego Gambetta, “Comment on ‘Corruption and Development,’” in Boris Pleskovic and Joseph E. Stiglitz, eds. *Annual World Bank Conference on Development Economics 1997* (Washington: The World Bank, 1998), p. 58. Diego Gambetta, *The Sicilian Mafia: The Business of Private Protection* (Cambridge: Harvard University Press, 1993).

time were private police that offered protection for these segments of the economy. The same is true of urban gangs of recent decades that protect the illegal drug trade, as well as the armed political groups calling themselves radical socialists that protect cocoa agriculture in Colombia.

A mafia is a stationary bandit who functions as a mini-state in a small area. Olson would argue that a mafia should be more conducive to economic activity and investment than a state of anarchy, but not as conducive as a state that protects the entire economy over a larger area. It is not surprising that mafias are more often found in less dynamic economies or segments of the economy. If the opportunity for great enrichment increases in an area with economic development, then a stronger stationary band with greater military force—the legal state—will likely act to supplant the smaller and weaker bands.

Nevertheless, mafia protection is more similar to government protection than we like to recognize. In both cases the economic actor has no choice but to accept the protection and pay for it. A person who refuses to pay for mafia protection risks physical injury or worse, while government is more civilized. It simply imprisons those who refuse to pay for its protection. Yet, if the mafia and government are basically competitive institutions offering a similar service to economic actors, government has a natural advantage because of its ability to muster superior force—if it chooses to do so.

The Russian gangs and mafias need to be understood in the same terms as Western ones. Many see the Russian mafia as the natural continuation of the illegality in the Soviet second economy, but nothing could be further from the truth. As Chubais correctly understood, those in the second economy had capital, entrepreneurial instincts, daring, and business skills. Their natural choice would have been to

use their funds and skills to become major legitimate businessmen in the new economy—as do their counterparts in the West when conditions change. Joseph Kennedy, the father of President John Kennedy, was driven by a desire for respectability after the end of Prohibition, and his Soviet counterparts would be no different. If some persons from the second economy did not perceive the wisdom of making a transition to legal economic activity, the new politicians of post-Soviet Russia had every interest in using the full force of the state against them. The new politicians, after all, had a strong interest in monopolizing corruption for themselves.

In the United States, economic activities not protected by the law and, indeed, harassed by it (e.g., illegal drug sales) are relatively limited now, and so too is the sphere in which gangs serve as the major police force and legal system. If they try to extend their activities into other spheres of the economy or into living areas outside selected poor neighborhoods, the response of the police is harsh. But, in Russia there has been insufficient legal protection for any part of the economy, and hence the sphere of mafia protection has been much wider. Large businesses increasingly hired their own private force to protect against independent forces, but the only way to combat the mafia on a mass basis was to build up state institutions as a legal competitor.

GOVERNMENT CORRUPTION AND INVESTMENT

We usually contrast government officials and economic actors, but the individuals working for the government are themselves participants in a labor market. They too are presumably motivated by the same calculations of relative benefit as those seeking other employment, but since the government offers more job security, it may be able to attract employees at lower cost. Since this combination of higher

security and lower wages is most appealing to the risk-averse, it should lead to a government civil service that is less inclined to take risks by violating the law. Indeed, this is the major reason to create an incentive system that attracts less entrepreneurial and innovative people for government work than work in the private sector.

The incentive system for government employees does not, however, always correspond to our preconceptions. In developing countries, government employment, either military or civilian, may be less secure than that in the traditional agriculture sector, and it may offer much higher rewards. The risk of punishment for illegality may be low, and what we call “conflict of interest” may not even be defined as illegal. High economic rewards in the urban private sector may be difficult to obtain and may require government assistance. In these circumstances the structure of costs and benefits of government employment should attract those who are not risk-averse and who are trying to maximize personal economic gain. In short, it may attract those who are primarily motivated by the chance for corruption.

The levels of corruption are generally higher in the early and middle levels of industrialization than in advanced industrial society not because people are less moral, but because the restraints are less well-developed. Karl Marx lived in such a period in Europe. He was wrong to see government as the tool of some united bourgeois class, but individual government decisions at that time often did, in fact, result from the subordination of officials to the payments of individual bourgeoisie. Marx failed to understand that it would be possible to increase the regulatory role of government in a way that could substantially improve the situation.

Russian neoliberal economists began as Marxists, and they shared Marx’s belief that the state had no useful role in a cap-

italist economy. Yet, they rejected Marx's insight into the defects of early capitalism because they did not understand its base in their own models of individual rationality. They did not comprehend that self-interested "economic men" *should* engage in illegal and corrupt activities if they are profitable. They did not understand that the massive corruption witnessed in Russia flowed logically from their own assumptions, not from defects in Russian character.

Although many now claim there were especially high levels of corruption in the Communist period, the opposite was true. The Soviet economic system made it very difficult to utilize ill-gotten wealth to acquire property in Russia, and the KGB-protected Iron Curtain made it very dangerous to have foreign property and foreign bank accounts. Hence the cost-benefit ratio for large-scale corruption was much less favorable than in a normal country at early and middle stages of capitalist development.

For this reason, the opening of Russia to the world economy, the greater ease in having foreign accounts, the possibility of emigration, let alone the opportunity to acquire property at home would have increased the level of large-scale corruption in Russia sharply, regardless of other factors involved.²¹ The problem was further exacerbated by a breakdown in discipline within the government apparatus. In the words of Andrei Shleifer and Robert Vishny, two of the leading participants in Russian privatization,²²

²¹ The problem of corruption is not limited to Russia among former Communist states. See Hilary Appel, "Corruption, Democratization, and Economic Reform: Lessons from the Czech Case," Paper presented to the Annual Meeting of the American Political Science Association in Boston, September 3–6, 1998.

²² Andrei Shleifer and Robert W. Vishny, *The Grabbing Hand: Government Pathologies and Their Cures* (Cambridge, Mass.: Harvard University Press, 1998), pp. 97–98. Shleifer had been Larry Summers' research assis-

In the old-time Communist regimes . . . it is always clear who needs to be bribed and by how much . . . In some African countries, in India, and in post-Communist Russia . . . the sellers of complementary government goods, such as permits and licenses, act independently. Different ministries, agencies, and levels of local government all set their own bribes independently in an attempt to maximize their own revenue . . . The problem is made much worse in many countries by free entry into the collection of bribes. New government organization and officials often have the opportunity to create laws and regulations that enable them to become providers of additional required permits and licenses and charge for them accordingly. Having paid three bribes, the buyer of these inputs learns that he must buy yet another one if he wants his project to proceed.

The analysis of corruption must, however, be pushed further. In particular, why is corruption especially widespread in the early and middle stages of capitalist development? Moisei Ostrogorski's and Lewis Namier's famous description of the corruption in the relation between King and Parliament in 18th century England reads eerily like Yeltsin's relationship with the Duma. The United States bank controversy of the 1820s really was a struggle between politicians over which of them would succeed in having federal money deposited in their personal banks or those of their friends. The generation of the American "takeoff" of the 1850s was called "the

tant at Harvard and was said to be quite close to him. *Wall Street Journal*, August 13, 1987, p. 1. When Shleifer discussed the privatization program in which he himself was involved, he was always optimistic and showed little awareness of the logic of the steps he had advocated. See, for example, Maxim Boycko, Andrei Shleifer, and Robert Vishny, *Privatizing Russia* (Cambridge, Mass.: MIT Press, 1995), p. 9. A later example is his lyrical description of privatization in the foreword to Joseph R. Blasi, Maya Kroumina, and Douglas Kruse, *Kremlin Capitalism: The Privatization of the Russian Economy* (Ithaca: Cornell University Press, 1997), pp. ix–x.

plundering generation,” while the term “Robber Baron” was coined in 1867 and was applied to the major entrepreneurs of the entire period of rapid growth until the end of the century. The corruption in the Pacific Rim countries of the second half of the 20th century is legendary.

The corruption in the early stages of capitalist industrial development is almost always treated as a factor that retards economic growth.²³ The eradication of corruption, especially that associated with leading politicians, is a perennial demand of the IMF. In fact, the period of widespread corruption often is associated with prolonged surges of growth in such a wide range of countries that it cannot be seen wholly in negative terms. Indeed, the reduction in the scale of the corruption is usually associated with declines in rates of growth.

Large-scale corruption, in fact, can play an important role in promoting investment and growth at a certain stage of capitalism and even in establishing the constitutional democracy that is so important in protecting a market economy. When people do not trust impersonal financial institutions and when the latter do not trust potential investors seeking to borrow, a close personal relationship between investors and government, cemented by economic self-interest on both sides, serves many useful functions.

As often noted, government investment projects often serve purposes of prestige rather than economic growth, and they are frequently counterproductive. By contrast, private investment by corrupt government officials or joint participation by investors and high government officials in a private investment project should promote economic growth.

²³ For a summary article with an extensive bibliography, see Susan Rose-Ackerman, “Corruption and Development,” *Annual World Bank Conference on Development Economics, 1997* (Washington: World Bank, 1998), pp. 35–57.

The government official, especially if he invests himself or indirectly participates in the investment, is motivated to seek the best long-term investment in a way often not caught by the literature on government rent-seeking. Moreover, the project has a better chance of success because the problems of legal protection and informal government assistance are solved.

Clearly high-level corruption is inequitable, and, if carried to an extreme over the long run, it can produce the problems of monopoly. But to some extent the process is self-correcting. As officials age and as they and their children think more of the future, they develop an interest in a more impersonal system of legal protection precisely because they want to be protected from the next ruler and his favorites. As society becomes wealthier, others want to defend interests other than just those of a narrow economic elite and of economic growth alone. The establishment of constitutional democracy to protect property gives greater power to people more concerned with consumption. Not surprisingly the defense of these other values produces a decline in the rate of growth, but this only demonstrates the close connection between high-level corruption, investment, and growth at the stage that the corruption is most rampant.

From this perspective, the enormous concern about the level of high-level corruption in Russia in the 1990s is quite misplaced. Given the absence of a functioning banking system, government as an institution and government officials as individuals inevitably had to be key players in the investment process. The real issue was not the corruption, but what the corrupt did with their money. Any defense of corruption assumes the money will be invested at home. Indeed, there is every reason for this to occur if the economic incentive system is working properly. An investor with inside knowl-

edge and government protection should receive far higher returns by investing in an emerging market than in a Swiss bank account or even Western mutual funds.

The clearest sign that the Russian incentive system was not functioning properly was not that corruption occurred, but that the corrupt did not find it profitable to invest at home. This was true even in the mid 1990s when Westerners saw Russia as a highly profitable emerging market. Corruption should have facilitated investment, but those with inside knowledge saw that capital flight was the most profitable use of their money. The factors in the incentive system that led the corrupt not to invest were also the same that influenced potential honest investors as well, and these factors should be the focus of our attention.