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CRIME AND THE POLITICAL ECONOMY OF RUSSIAN REFORM

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Abstract

The reform era in Russia has been marked by a massive increase in reported crime, including organized crime. The purpose of this paper is to look more closely at the interaction between crime and economic reform measures. Widespread economic crime in the old system paved the way for the removal of central planning, though continuing economic crime may hinder or roll back the economic transition. Corruption and organized criminal activity, in particular, are explored, in both the pre-reform and reforming Russian economies. The theme that emerges is that the standard Western interpretation of crime is inappropriate under the conditions of Russian transition. While a large increase in corruption or organized crime would surely be economically detrimental in the United States, the impact is decidedly more ambiguous in Russia.

"It must be remembered that there is nothing more difficult to plan, more doubtful of success, nor more dangerous to manage than the creation of a new system. For the initiator has the enmity of all who would profit by the preservation of the old institutions and merely lukewarm defenders in those who would gain by the new ones."

---Machiavelli.

1. Introduction

The reform era in Russia has been marked by a massive increase in reported crime. Between 1985 and 1993, overall recorded crime doubled. Following a 6% decline in 1994, crime resumed its upward trend in 1995. Equally dire is the prevalence of organized crime: as of late 1995, some 8,000 organized criminal groups were said to be operating in Russia. Charges and rumors of corruption at the highest levels of government are pervasive. Sensational crimes such as kidnappings or attempted sale of radioactive materials have become common. Murders and attempted murders doubled between 1991 and 1994. Dozens of murder victims have been high-profile citizens.

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including prominent bankers and members of the State Duma. Economic motives appear to be behind many of these crimes, highlighting the extreme physical risks involved in conducting business in transitional Russia.

The increase in Russian crime is generally attributed to a disintegration of governmental authority, border control, and crime fighting capability during the reform period, coupled with a substantial liberalization of economic activity; thus, economic and political reform is widely viewed as being the causal agent behind the increase in crime. Potential influence in the opposite direction also occasionally is noted: the massive increase in crime might spur an anti-reform backlash. The harsh and probably unconstitutional anti-organized crime measures that President Yeltsin announced in mid-1994—a year proclaimed in Russia as the Year of the Fight Against Organized Crime—are possibly a harbinger of such a backlash.

The purpose of this paper is to look more closely at the interaction between crime and economic reform measures. The focus primarily will be on economic crimes, which can be loosely (and circularly) described as those crimes that are motivated primarily by economic gain; most property crimes, for example, are economic crimes. Corruption and organized criminal activity, in particular, will be explored. The theme of this exercise is the notion that the standard Western interpretation of crime is inappropriate under the conditions of Russian transition. Thus while a large increase in corruption or organized crime would surely be economically detrimental in the United States, the impact is decidedly more ambiguous in Russia. This point is just another version of the theory of the second best: in the woefully inefficient conditions that prevail in Russia, the additional "distortions" brought about by economic crime may represent an improvement.

The arguments presented here are quite speculative, and many of the contentions fall short of legal standards of proof such as "beyond a reasonable doubt" or even "a preponderance of the evidence." Information on crime is frequently of poor quality, even in Western market economies, and is likely to be even more so during a systemic reform in which many laws are changing simultaneously. Research on the pre-reform Soviet economy encountered great difficulties in achieving consensus on the facts, much less on their interpretation, and in many cases reform has actually exacerbated the difficulties. As Hewett (1988, p. 160) put it, the "problem is one of weighting the various anecdotes, and there is no easy solution. Drawing inferences from a mass of anecdotes is a highly subjective enterprise and is not amenable to replication by others. The best one can do is to make prior assumptions (or biases) clear." My bias in this paper is to focus on the positive aspects of economic crime, without (I hope) neglecting the negative aspects. The rationale for adopting this stance is that the positive aspects of crime tend to be less obvious, and hence less remarked upon, than the negative aspects.

The remainder of this paper is structured as follows. Section 2 discusses the interplay between various forms of economic crime and economic reform in Russia and the pre-reform Soviet Union.
Sections 3 and 4 are addressed more specifically to the post-Soviet era and offer brief remarks on corruption and organized crime, respectively. Section 5 provides conclusions.

2. Economic Crime and Reform

"...the second economy, grafted onto the present institutional setup in the USSR, is a kind of spontaneous surrogate economic reform that imparts a necessary modicum of flexibility, adaptability, and responsiveness to a formal setup that is too often paralyzing in its rigidity, slowness, and inefficiency. It represents a de facto decentralization, with overtones of the market."

----Gregory Grossman, 1977

Good Rules and Bad Rules

Let me begin with a very stark, over-simplified characterization of good and bad laws. There is a strong presumption that voluntary exchange between competent adults is mutually beneficial. In the absence of negative third party effects, such exchanges are Pareto improving. Coercive exchanges ("your money or your life," or almost any type of violent crime) carry no such presumption.8

Laws that seek to prohibit Pareto-improving, voluntary exchange are, in some sense, bad rules. Alternatively, laws that prohibit or regulate privately profitable but socially detrimental activities, such as theft or other coercive relations, are good rules. Breaking a bad law can result in a Pareto improvement in society. Breaking a good law probably makes society worse off.9 Of course, there are many rules that seek to regulate voluntary exchanges, perhaps for the purposes of tax collection or to minimize third-party effects. As these taxes or regulations increase, they become closer to prohibitions. Evasion of these rules, in general, has ambiguous social effects, even in the absence of direct third-party effects. The government must collect revenue through some means, so tax evasion shifts tax burdens onto other parties. If the tax on a transaction would be sufficient to preclude the exchange, however, evasion would seem to offer a social improvement, and indeed, countries often tolerate substantial tax evasion.

The Soviet era

The Soviet planned economy was full of "bad" economic rules, and similarly full of evasion of those rules. The rigidities of central planning virtually required informal or illegal activity, even for state-owned enterprises to meet the plan. Many goods were illegally allocated outside of the plan. Price controls were evaded by bribes, whether monetary or in-kind. Private economic activity flourished underground. Theft of state property was common enough that it became an accepted practice, virtually a standard part of compensation. Much of this economic crime, including theft from the state, was not viewed negatively by Soviet citizens.10
Economic crime had a profound influence on the pre-reform "equilibrium." The information that reached planners was altered by economic crime, and over time this undoubtedly affected planner decisions. For instance, official salaries were lower in occupations that provided good opportunities for second economy earnings; in effect, planners offered lower official wage rates to offset theft or bribe income.  

There were two types of pre-existing economic crime, however. One type consisted of those elements of Soviet criminal activity that furthered plan fulfillment, improved state-owned enterprise performance, or filled in productive and distributional gaps of the official economy. Simultaneously, however, some second economy activity hindered plan fulfillment and lessened central control; much of the theft from the workplace, for example, probably was of this nature.  

Economic crime apparently increased over time. While reliable data are quite limited, most observers have concluded that the Soviet second economy expanded noticeably throughout the Brezhnev era, and by the late 1970s it was estimated to provide on the order of one-third of the income of urban households.  

**Perestroika-era reforms**

The increase in second economy activity was in a sense a gradual economic reform, as the quote that opens this section indicates. A major goal of the official reforms that comprised Mikhail Gorbachev's *perestroika* was to legitimize this pre-existing private economic activity. The 1986 Law on Individual Labor Activity legalized household-level business, but continued to prohibit the hiring of non-family members. The 1988 Law on Cooperatives allowed unrelated individuals to enter business together, though there were still many restrictions on the type of business and the hiring of labor. The Law on State Enterprises (effective January 1988) officially ended plan targets, but they largely were replaced with functionally-similar "state orders," while above-plan production was liberalized. Taken together, these measures were in significant measure an explicit recognition of what had long been a *fait accompli*. As such, both the efficiency and distributional changes that directly accompanied the reforms were muted.  

**Economic crime and the demise of central planning**

Russian economic reform eventually moved beyond the reforms of *perestroika*, and included the near-complete destruction of the system of central planning. Such an outcome was clearly unanticipated and undesired by Gorbachev and most other leading Soviet officials at the beginning of *perestroika*. Rather, the goal had been to offer a more efficient style of socialism. But why would the authorities eventually choose to jettison central planning, given that many second economy incomes: (1) were tied to rents or positions that were created by the planning mechanism; (2) would disappear with any reform that abolished central planning and price controls; and (3) were often
earned by influential individuals? The potential loss of lucrative positions or illicit income streams by those well placed in the state and party hierarchy would seem to create a strong anti-reform constituency, at the same time that the marketizing aspects of crime reduced the need for an official reform. Both Grossman (1989) and Millar (1988) view economic crime as creating a barrier to reform for such reasons. 15

An examination of the efficiency and distributional impacts of crime, however, suggests instead a threshold effect. At low levels, Soviet economic crime tended to impede systemic reform; alternatively, high levels of economic crime promoted reform. The reasoning is as follows. At low levels of economic crime, full-scale market-oriented reform involves massive redistributions of income, and substantial efficiency gains. But the potential redistributions will dominate the cost-benefit calculus of policy makers. 16

Let me elaborate. Two types of potential distributional impacts are particularly salient during economic liberalization. First is the possibly negative impact among poorer segments of society, particularly those who might find themselves unemployed after reform. This distributional effect can be mitigated by unemployment benefits and other targeted, social safety-net measures. Second, and perhaps more importantly for the decision to undergo reform, is the potential loss of perks and privileges by those well-placed in the state-sector. Politically-influential people who were collecting rents in the old system would have good reason to oppose reforms that might threaten the continuation of those rents.

As economic crime spreads, however, more and more of the economy is essentially transformed into a market system. Poor people have increasing difficulty finding goods in state stores, so they are forced to pay market prices, even prior to official reform. A radical reform, then, becomes largely a ratification of the existing situation, like the perestroika-era reforms. For this reason, both types of potential income redistributions that were noted above are diminished, if the reforms validate the informal property rights over income flows that have already been captured by important state officials.

While the distributional impacts of reform are lessened by increased economic crime, there are still substantial efficiency benefits. Operating illegally or informally exacts tremendous transaction costs, as people must conceal their activity and limit its scale. 17 Legalization of private economic activity and the formalization of pre-existing, informal property rights would greatly reduce such transaction costs. At high levels of economic crime, then, market-oriented reforms are likely to be marked by relatively small redistributions but significant savings on transaction costs. Widespread economic crime in Russia served as a catalyst of, and not a substitute for, market-oriented reform.
A plausible version of the positive feedback, "threshold" model provides one explanation of the events that led up to the Russian market-oriented reforms of January 2, 1992. Perestroika-era measures that largely were aimed at legalizing second economy activity and improving the performance of state-owned enterprises--most particularly, the Law on Cooperatives and the Law on State Enterprises--produced the unintended side effect of an increased government budget deficit. This deficit was created both by falling "tax" revenues as enterprises were allowed to keep a greater portion of their profits and foreign exchange earnings, and by increased expenditures as the new laws greatly expanded the opportunities to evade state-sector wage controls. The budget deficit was monetized, leading to inflation.

At this point, a positive feedback loop is initiated. The inflation increases the gap between the fixed state-sector prices and prices on the informal market. The larger price gap in turn increases the incentive to divert goods out of the state sector, and the reforms simultaneously facilitate quasi-legal methods of diversion. Even entire factories can be so diverted, by various channels of "spontaneous privatization."¹⁸ The increased diversions serve to increase the budget deficit further, leading to more inflation, a larger gap between state and free-market prices, and so on.

The expanded market activity intended by perestroika inadvertently lowered the costs and increased the benefits of operating outside state controls, undermining the state sector and the official price controls, in advance of official privatization and price liberalization. But once the informal activity was sufficiently broad, price liberalization and official privatization no longer represented a "big bang." Rather, they largely ratified the existing situation, in which, for example, most Russians were already paying market prices for many goods, since the goods were unavailable in the state sector.¹⁹ But the necessity to informally divert goods and assets to free markets used up considerable real resources, which could be redeployed following legalization.

I have suggested that the pre-existing rents tied to informal behavior from participants within the planning network were not a large barrier to dismantling the planning system--at least once the informal behavior became extensive. This argument implicitly requires, however, that reforms validate and formalize the pre-existing informal property rights. Russian reform largely accomplished this ratification, primarily by providing workers and managers with majority ownership of enterprises during privatization. Higher level state/party officials, many of whom were beneficiaries of informal economic behavior in the pre-reform era, have also tended to do well during the transition.²⁰

Hellmann (1991) offers supporting evidence from the Soviet banking industry, in which state-sector bureaucrats opposed reforms in the early stages, only to promote them later. The difference in the bureaucratic response to reform is that the initial reform was imposed from the center on the banking sector. One unintended result of the first wave of reforms, however, was an increase in
informal opportunities to evade state restrictions, thanks to the formal decentralization of power. The second wave of reform, then, was sparked by a massive expansion in what were basically second-economy dealings undertaken by the new commercial banks and their related state-owned enterprises. These reforms, initiated and promoted by banking insiders and only later ratified by the central government, formalized the expanded second-economy operations.

3. Corruption

"Understanding 'corruption' first in its narrower sense of the taking of bribes by officials in relation to the performance of their official functions, there can be no doubt that it is an extremely widespread phenomenon in the U.S.S.R., reaching into nearly all corners of society and up and down nearly all levels of the formal hierarchy."

---Gregory Grossman, 1979

Corruption involves the misuse of an official position for personal gain. The social consequences depend, once again, on the nature of the corruption and the available alternatives. If corruption allows individuals to evade burdensome and inefficient government restrictions, than it may represent a Pareto improvement. Alternatively, if corruption allows the evasion of good rules, or if it consists of payments to government agents to carry out their official duties, then it probably is socially undesirable. Widespread corruption is generally associated with poor economic outcomes, though this may be a reflection not of the corruption itself, but rather of the quality of the rules that lead to corruption. Furthermore, it has often proven difficult in practice to dislodge a high-corruption equilibrium.

Klitgaard’s (1991, p. 75) heuristic equation for determining the likely amount of corruption is

\[ \text{corruption} = \text{monopoly} + \text{discretion} - \text{accountability} \]

It is unsurprising then that the pre-reform Soviet economy was marked by a huge degree of corruption, as local Communist Party officials had a monopoly on power, great discretion over what they could choose to overlook, and little accountability for their illegal actions. As with other forms of economic crime, pre-existing corruption—much of it of the Pareto-improving variety—seemingly created an important anti-liberalization constituency.

Many changes have occurred during the reform era, however, that may influence the interaction between corruption and reform. First, the probability that corruption will be exposed has apparently risen, as a result of the demise of Communist Party control of the judiciary and of the rise in journalistic freedom. Accountability has risen. As a partial offset to the increase in accountability, however, the value of a job in the state sector has probably declined relative to private sector opportunities. Since loss of employment is the standard punishment for exposed corrupt officials, the lessened attractiveness of state-sector employment has, in itself, increased the incentives for corruption. While accountability may have risen, the punishment for those exposed may well have declined.
The nature of corruption also has changed somewhat during the reform era. Corrupt officials in the old regime were often offering protection for illegal activities. With liberalization, it is frequently licenses for the right to operate a legal business that are being peddled, including rights for real estate use and access to utilities. But it seems that entrepreneurs can often evade licensing requirements and still operate. One form of economic crime--operating a business without a license--limits the extent to which another form--official corruption--can take place. While a corrupt official therefore is likely to have more potential clients during the transition, the leverage over any one client may well be reduced.

One area where a good deal of official corruption has been exposed is in the issuing of export licenses. Simultaneously, many unlicensed exports of oil and non-ferrous metals apparently take place, though undoubtedly with payoffs to border guards and other state officials. Such widespread evasion of export controls may well promote further reform, because it undermines the rationale for the licenses and simultaneously pressures the internal price controls. A similar argument has been made with respect to foreign investment in China. Advantageous rules for foreign investment led to informal methods of laundering domestic investment (through Hong Kong, in particular, and probably in concert with corrupt officials) as foreign investment, to take advantage of the favorable treatment. This form of economic crime and the corruption necessary to protect it led to pressure to liberalize conditions for domestic investment as well.

Interactions between organized crime and corruption alter the effects of corruption. Organization allows for a criminal syndicate to enter into a long-term, repeated relationship with corrupt officials. Such a relationship reduces uncertainty, and helps to overcome various coordination and bargaining problems that can arise when permission from multiple officials must be secured. Organized criminals may likewise be better than individual entrepreneurs at finding the lowest cost means to operate a business, whether that involves payments for a license or protection money for illegal operation.

Corruption, or even the perception of corruption, differentially impacts foreign business people. Foreign direct investment in Russia is undoubtedly chilled by the perception that payoffs will have to be made to a good many corrupt officials (and perhaps free-lance racketeers.) Foreigners are in a much poorer position than natives to "know the ropes," to understand which payments are necessary and which can be avoided. Foreknowledge of the potential for corruption undoubtedly dissuades some foreigners (and domestic citizens) from investing in Russia, and induces the selection of relatively "unethical" business people among those who do invest.

It remains difficult to ascertain whether corruption promotes or hinders continued economic reform. There are some forms of corruption--primarily those that permit regulations to be circumvented, such as the laundering of investment as FDI in China--that seem to promote reform, by pressuring further liberalization. Likewise, the possibility for corruption to divert tax revenues
from the state to officials with discretionary power can lend an additional financial motive to the state to liberalize. Simultaneously, the discouragement of entrepreneurs and foreign investors by the existence of widespread corruption seems to work against economic reform, though paradoxically, organized crime can help to mitigate this negative effect. A condition that renders corruption more reform-enhancing, once again, is that those who gain from corruption--primarily state officials with discretionary powers emanating from economic controls--be unable or unwilling to try to prevent the removal of the conditions that make their authority a valuable asset. Here, conditions during the Russian transition are more favorable than they are in other settings with significant corruption, since the discretion and the monopoly conditions that play such an important role in corruption are reduced in the natural course of transition, at the same time that accountability can be increased. And perhaps more importantly, lucrative opportunities in the emerging private sector may make officials less intense in defending their rents from corruption--especially since the officials themselves are often shaping the rules that define their opportunities.

4. Organized Crime

"...a good many economic and business principles that operate in the 'upperworld' must, with suitable modification for change in environment, operate in the underworld as well--just as a good many economic principles that operate in an advanced competitive economy operate as well in a socialist or a primitive economy."

--- Thomas C. Schelling

Organized crime has an even worse reputation than corruption in leading to poor economic outcomes, and in being persistent. Nevertheless, conditions during the Russian transition again present a slightly more favorable picture of organized crime.

For organized crime to prosper, clients must be unable to evade demands for tribute. It is more difficult to evade such demands if you are operating illegally, since you cannot turn to the police for protection. The more "visible" your business, similarly, the more difficult it is to avoid the mafia. Small businesses that deal in cash are particularly vulnerable, since the number of people who must deal with the mafia is reduced for such businesses, and the owners, who are also generally the bookkeepers, can disguise payments for protection in the books. At the same time, some businesses need mafia protection, primarily to facilitate contract enforcement and debt collection, but perhaps also to provide security against other criminal threats.

The pre-reform system offered particularly attractive conditions for organized crime, where the Communist Party provided the organization, since most private economic activity was illegal and the party controlled the police and the judiciary. As a result, "second economy operators of even modest size require[d] multiple and periodic payoffs--to administrative supervisors, party functionaries or secretaries, law enforcement personnel, innumerable inspectors and auditors, and diverse actual or potential blackmailers."
Conditions during Russian reform have promoted the mafia on both the supply and the demand side.\textsuperscript{33} Increased monetization of the economy (particularly the wholesale market, the official part of which previously employed "non-cash rubles") facilitated cash operations, which are the preferred method of exchange in the underground economy. Further, business people continually suggest that it is impossible to remain in business if you attempt to operate entirely within the law and pay all taxes. Since most businesses therefore behave illegally, they are not in a good position to combat demands for protection payments, while the police are themselves notoriously corrupt.\textsuperscript{34} The almost complete lack of public enforcement of private contracts creates a demand for mafia protection, even among potentially law-abiding firms, while the apparent increase in ordinary criminal activity also generates a demand for private protection.\textsuperscript{35} And the partial economic liberalization has resulted in a great increase in the number of private businesses, as well as many mafia syndicates competing to offer protection.

Organized crime (like corruption) can hinder the development of a legal market economy in indirect fashion. Businesses that must make protection payments must find the means to do so, and perhaps in an opaque fashion. Such businesses will then be more likely to operate (at least in part) underground, outside the purview of the official tax authorities. The result can be higher tax rates on legitimate businesses, and in Russian conditions, higher inflation. The special susceptibility of small firms to mafia infiltration could be a source of economic difficulties, since small businesses are an important engine of growth in transitional societies.\textsuperscript{36}

Mafia activity has, of course, created its own vested interest in preventing the development of contract law or other substitutes for mafia protection. Will these vested interests be enough to derail further economic reform? My suspicion is that they will not, for two reasons. First, there are "countervailing powers" in the form of associations of business people and large, now primarily "privatized," enterprises. Second, the old syndicate, the Communist Party, was unable or unwilling to prevent substantial economic liberalization. Current mafias lack the monopoly power of the former CPSU, and are much less well-organized, so their ability to prevent reform would seem to be much diminished relative to the CPSU.

The other possibility for organized crime to halt reform, alluded to in the introduction, is that the widespread violence and general unsavory behavior of mafias may provoke a turn, perhaps with substantial popular support, to a restrictive authoritarian regime. While this is clearly a risk, once again there are reasons for thinking that it is unlikely. First, perhaps the most-discussed "model" for such a regime is Chile under Augusto Pinochet, where market-oriented reforms were undertaken under an authoritarian political regime--not to say that this is a hopeful scenario. Second, as the U.S. found out through the abolition of prohibition, among the best methods of combatting organized crime are removal of the very government restrictions that in Russia are impeding the development of a market economy. Third, the public may not view crime as such a high price to pay for reform.
Gaddy (1993), for example, presents regression results indicating that high levels of reported crime are associated with increased support for economic reform, as evidenced by regional voting patterns in the April 1993 referendum. A poll taken in Moscow, perhaps the crime capital of Russia, reported in Izvestia in May, 1994, indicated that only 30% of Muscovites were willing to limit democratic freedoms for increased public order and living standards; 42% were not in favor of such a trade, and 28% were on the fence. Together, these suggest that there is some hope that while the strength of Russia’s commitment to becoming a "normal market economy" is tested by organized crime, that commitment will prove lasting.

5. Conclusions

This paper has argued that low levels of economic crime in the USSR served as substitutes for official reform; however, as the scale and scope of crime increased, crime tended to promote reform. The basic reasoning is that at high levels of economic crime, the distributional consequences of reform are muted, while substantial efficiency gains can still be captured. Further, it has been suggested that increases in economic crime during the Russian transition are not as detrimental in economic terms as they would be in mature market economies.

The transition has seen a shift in Russia towards better laws. Evasion of the new rules, therefore, is less likely to promote social welfare. Furthermore, economic liberalization has provided whole new categories of crime, such as financial frauds, that did not exist in the pre-reform system. There was, of course, no experience with policing such crimes. Criminals often were able to respond more quickly than the police or the tax collectors to the changed environment. Improved enforcement of new laws, including tax laws, is an important element of the sustainability of reform. Continued high-levels of negative-sum crimes would seem to offer pressure for the reimposition of controls, as noted in the introduction.

While the economic laws in Russia have improved relative to the Soviet days, the liberalization has been much less complete than in Western market economies. Here is a description of the Russian economy in October 1995 from former Acting Prime Minister Yegor Gaidar:

"...the main problem of present-day capitalism that has formed in Russia is as follows. It is the problem of the utmost intertwining of property and power. If we look at the operation of the Russian enterprises, the work of government agencies, in Moscow, in the regions, we will see constantly the closest intertwining of business and bureaucracy. In the majority of cases the success of an enterprise depends not on the ability of the director or the owner to organize normal production, but on his ability to correctly give bribes, on whether he has sufficiently high patrons, his ability in this connection to secure for himself a set of individual benefits and exceptions from the rule, his ability to get cheap money out of the budget, and so on."

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Despite (or in some instances, because of) organized crime and corruption, there is an extensive amount of business activity conducted in Russia. For many businesses, security and protection from the discretionary powers of government officials represent standard business expenses, but not overwhelming concerns. And, as noted, the providers of protection are not always simple extortionists, even when they have established their positions through coercion. Mafiosi have some incentive to provide business services such as debt collection and contract enforcement to their "clients," and these services can range in form from benign to violent.

What is to prevent the establishment in Russia of a persistent, high crime equilibrium, as in parts of Sicily or in corrupt developing countries? First, the simultaneous liberalization of a vast array of economic activities that is still continuing in Russia improves opportunities in the legal private sector. Second, the rules of the new system are being shaped by those who could otherwise derail reform. Together, these do not preclude the possibility of continuing high crime, but they make it less likely. Of course, pressure from the IMF and other dispensers of aid to jettison extensive licensing and other government controls can also be helpful.

Speculation no longer being illegal in Russia, I am tempted to further abuse the privilege with one last thought, namely, a conjectured "law of motion" of socialism based on economic crime. Centrally-planned economies, often effective at mobilizing resources towards a clear goal such as winning a war or industrializing with known technologies, have a very difficult time innovating, in adjusting production in ways that cannot be anticipated. Further, the price controls limit the information available to planners about relative scarcities. Over time, therefore, an economy that adopts central planning will face increased resource misallocations, and see its average living standards begin to slip relative to market economies that started from similar conditions. In order to reduce resource misallocations and to lessen the gap in living standards, central authorities will tolerate growing illicit market activity. (The authorities may engage in occasional crackdowns, but it will eventually become obvious that these do not solve the problem, and probably make matters worse. And the crackdowns are themselves half-hearted, as it is the authorities themselves who frequently benefit from economic crime.) Eventually the second economy will grow to such a point that its legalization will offer substantial efficiency gains (through lowered transactions costs), with relatively minor distributional consequences, since the distributional consequences were brought to bear pre-reform. Central planning may suffer from an internal, crime-based contradiction.
References


Endnotes

1. Machiavelli (1947 [1532], p. 15).


4. The deterioration in the Russian crime statistics predates perestroika, however; see Shelley (1992). Alexeev, Gaddy, and Leitzel (1995) suggest that the total amount of economic crime in Russia may well have declined during reform, while shifting to forms more directly harmful to the general population.


9. Rules tend to apply broadly, without taking into account all individual preferences or circumstances; some evasion of even "good" laws, then, can be socially efficient, as can adherence to a bad law. The violation of any law, however, could promote a general disrespect for the law, leading to socially excessive rule evasion.


12. The distinction between plan-supporting and plan-disruptive crime echoes Montias and Rose-Ackerman (1981), who refer to corruption that promotes the goals of the official organization as "organizational corruption," while corruption undertaken for private benefit is "individual corruption." Whether plan fulfillment was actually beneficial for the Soviet economy, as opposed to satisfying planner objectives, is another matter.


14. Evidence for this assertion can be found in Gorbachev (1987) and Aganbegyan (1989).

15. Grossman (1989, pp. 93-94) echoes Machiavelli in concluding that the second economy hinders reforms: "Those who fear losses know what they stand to lose; those who may gain informal income do not yet know it with any certainty. So the overall effect of the second economy is still against reforms."

16. In analyzing trade liberalizations, Rodrik (1991) introduced the "political cost-benefit ratio," a measure of the amount of income redistribution generated for every dollar of efficiency gain emanating from a reform.

17. Studies of the informal sector in developing countries provide a rich catalogue of transactions costs associated with illegal economic activity. See, e.g., de Soto (1989).

18. Johnson and Kroll (1991) offer a good description and analysis of this process.

19. This argument is spelled out in Leitzel (forthcoming).

20. Beyond the opportunities to formalize their pre-existing rents, many party/state officials were bright, ambitious people who could have been expected to do well in a less constrained environment. See Polishchuk (1994).

21. It is possible that corruption simply results in lower official salaries for government officials. The necessity of behaving discreetly, however, which is brought on by the illegality of corruption, tends to raise transaction costs. See, e.g., Shleifer and Vishny (1993).


23. Cadot (1987) notes the role of wage levels in determining the amount of corruption. The claim that the diminished importance of state jobs increases the incentives for corrupt activity assumes that private-market alternatives are not similarly diminished by the exposure of corrupt practice while in state employ. This probably is the case for street-level police officers, who now have fairly well-paid alternatives as private
security guards. A Moscow official reported on October 12, 1995, that 960 police officers in the city had been fired in 1995 for taking bribes or otherwise abusing their position; another 6,000 had other disciplinary action taken against them. (OMRI Daily Digest, No. 200, Part 1, 13 October 1995.)

24. See Perkins (1994, p. 35). The extent of such activity is mind-boggling, with Krugman (1994, p. 75) noting one estimate that statistics on FDI in China were inflated by a factor of six through the informal arbitrage.

25. See, e.g., Shleifer and Vishny (1993). Apparently corruption in Russia is fairly well organized: "...Moscow newspapers list the going rates for whatever ostensibly free government service you may need." This quote is from "Bribery: Tradition with a Twist," by Clara Germani, Baltimore Sun, October 11, 1995, p. 2A.

26. U.S. corporations are prohibited from bribing foreign officials by the Foreign Corrupt Practices Act. In some instances, this restriction may be evaded by hiring local consultants who discreetly handle the necessary payments.

27. A survey of Western firms that have invested in Russia, however, indicates that fear of crime or the mafia is not a significant disincentive to investment. The chief obstacle to FDI, rather, is the uncertain legal environment. Russian Economic Trends (1995, p. 119).


29. This point again echoes Hellmann (1991).

30. The discussion in this section draws on Leitzel, Gaddy, and Alexeev (1995).


33. The term "mafia" is applied broadly and indiscriminately in Russia, to almost any successful business person, common criminal, politician, or private security agent.

34. In an effort to determine the extent of corruption among traffic police, the Interior Minister sent a truck loaded with vodka on a 700 kilometer trip in August, 1995. The truck was stopped by police 24 times, and bribes were requested on 22 of those occasions (OMRI Daily Digest, No. 164, Part 1, 23 August 1995.)


39. Standard crime models often result in multiple equilibria, some of which involve low levels of crime and some of which involve high levels; see, e.g., Sah (1991), Lui (1986), and Andvig and Moene (1990).