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CONTRACTOR: The Brookings Institution
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RULE EVASION IN TRANSITIONAL RUSSIA

JAMES LEITZEL
Sanford Institute of Public Policy
Box 90245
Duke University
Durham, NC 27708-0245

"The world is not thy friend, nor the world's law;
The world affords no law to make thee rich;
Then be not poor, but break it and take this."
--Shakespeare, Romeo and Juliet

Abstract
The transition period in Russia has been marked by radical changes in the official rules, and by significant individual responses to the new rules—including widespread evasion of the new policies. A return to a normal policy regime—a slow treadmill of reforms—might be quite welcome after the momentous changes of the past few years. With small policy changes and time, state involvement in the economy can "wither away," to levels more consistent with long-term growth. However, the history of law-breaking in the Soviet Union is not a promising legacy for a country interested in developing respect for its new rules. The credibility of reforms requires not just a belief that new policies will be sustained, but that they will be enforced. The toleration of widespread evasion can lead to a general distrust in the government's commitment to any proposed rule change. Both the desire and the capability of the government to implement reform is called into question.

1. Introduction
Policy reforms change the official rules. If people obeyed the rules, in both letter and spirit, reform would be a conceptually simple task. People, however, are quite ready to violate or circumvent rules, as a few minutes observing the behavior of drivers will make clear. Such evasive behavior would present little difficulty for reformers if the extent and direction of rule evasion or avoidance could be determined in advance. In practice, however, the ingenuity shown by individuals pursuing their own best interests cannot be anticipated by dispassionate (or even passionate) policy analysts. As a result, the potential for rules to be evaded clouds the mapping from policy changes to economic outcomes. The problem is exacerbated during a systemic reform in which countless rules are changing simultaneously, and the degree of enforcement of the new rules has not been established.

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Rule evasion complicates policy making in a second way. To the extent that evasion is illegal and punishment is a possibility, individuals will want to conceal their evasive activity. Thus, measures of economic activity often fail to account for evasive or underground behavior. For this reason, policy makers may misunderstand the pre-reform conditions, and choose inappropriate reforms. Further, the impact of reform is difficult to assess if there is substantial unrecorded activity in both the pre- and post-reform situations, and if reform changes the extent and character of the hidden behavior.

Not all rules, of course, are created equal. A gross over-simplification is that laws that seek to prohibit voluntary exchanges (in the absence of negative third-party effects) are socially inefficient, while laws that prohibit or regulate coercive relations are good rules. Somewhere in between are rules that seek to tax or regulate, as opposed to prohibit, voluntary exchanges. Breaking a bad law can result in a Pareto improvement. Breaking a good law probably makes society worse off.

While evasive behavior complicates the analysis of policies, it simultaneously can promote reform. Widespread evasion of a rule serves to bring the rule to the attention of policy makers, who then can respond with increased enforcement, rule liberalization, or another policy change. This feature of evasion tends to contribute to efficient policies. Wide-scale evasion of good rules, such as those against violent crime, will tend to be met with stricter enforcement or harsher punishment. Inefficient rules that are violated with abandon, however, will be more likely to be altered, or become effectively dead letters through a lack of enforcement. The conclusion that evasion is an effective force in promoting desirable policy reforms is muted if the policy makers are the ones who are benefitting from the evasion, and if they cannot assure themselves of similar benefits in the reformed system.

The transition from central planning to a "normal market economy" in Russia highlights the various roles that the circumvention of rules plays in reform. The pre-reform economy included extensive second economy dealing, very little of it captured in the official statistics. One paradox of reform is that, despite a significant liberalization, subterranean economic activity apparently has increased during the reform era. Tax evasion is rampant. Crime, including organized crime, is a serious problem. The circumvention of government rules is so pervasive that some commentators question the efficacy of any policy change.

The purpose of this paper is to examine more closely Russian economic reform and evasive behavior. Section 2 concerns the pre-reform situation, while section 3 investigates those aspects of rule circumvention that have become important during the transition. Section 4 is devoted to the specific conditions of Russia and the role that evasion might play in future reforms.
2. Rule Evasion During the Soviet Era

"After 60 years of experience with a Socialist economy run by government agencies, nearly everyone seems to have devised ingenious ways to turn its shortcomings to his individual advantage."

--Professor Gertrude Schroeder, 1979.5

Rules governing economic activity were pervasive in the Soviet Union. The annual plan was a major source of rules, guiding the allocation of goods within the state sector. Prices and wages within the state sector also were centrally determined. Furthermore, the state sector was itself very large, due to rules that prohibited most forms of private economic activity.

The prevalence of rules within the Soviet economy was nearly matched by evasion of the rules. The rigidities of central planning virtually required informal or illegal activity, even for state-owned enterprises to meet the plan. Many goods were allocated illegally outside 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.6 Leonid Brezhnev was reported to have said, "No one lives on wages alone. I remember in my youth we earned money by unloading freight cars. So, what did we do? Three crates or bags unloaded and one for ourselves. That is how everybody lives...."7 That some forms of economic crime in the pre-reform system were not socially harmful is highlighted by the lack of social opprobrium attached to them.8

Almost from the beginning of Soviet power there was significant evasion of the economic rules.9 But it was only during the Brezhnev era that the second economy began to expand noticeably.10 Sixty years was enough time for people to devise "ingenious"—and generally illegal—methods to make the most of central planning. Early Gorbachev-era reforms attempted to legalize some of the existing activity, and encourage more private behavior. The consequence was a whole new set of loopholes for various forms of spontaneous privatization, leading to an inflation that further fueled the fire of evasion. Eventually, price controls and central planning were jettisoned, after they already had lost a good deal of their significance.11

High levels of evasion in the former Soviet Union served to erode the communist regime’s ideological underpinnings. The departure from Marxist-Leninist principles was so severe that it could not help but be noticed; it "had all gone rotten," as Shevardnadze said to an agreeing Gorbachev in 1984, and thanks to their privileged positions, they may have been among the last to know.12

The history of law-breaking in the Soviet Union is not a promising legacy for a country interested in developing respect for its new rules. The credibility of reforms requires not just a belief that new policies will be sustained, but that they will be enforced. The toleration of widespread evasion in the pre-reform period can lead to a general distrust in the government’s commitment to
any proposed rule change. Both the desire and the capability of the government to implement reform is called into question.

3. Evasion in Transition

"The criminality and corruption of the former regime has already become standard operating procedure in the new." --Stephen Handelman

Liberalization during the Russian transition has resulted in substantially loosened controls on private economic behavior. Forms of rule-breaking that were prevalent in the pre-reform system, such as circumvention of price controls or "speculation," are, for the most part, no longer against the rules. Nevertheless, there remains a good deal of corruption, illegality, and underground activity. Why?

First, the rule changes during the reform era have gone well beyond the legalization of pre-existing activity. The more-or-less general prohibition against private economic activity has been replaced by a host of new regulations and taxes at different levels of government. The liberalization has been far from complete, and private activity officially remains much more tightly controlled than in the U.S., for example.

Legal Uncertainty

Besides presenting a large change in the rules, the transition also has brought increased uncertainty as to what the rules really are. Laws are murky, changing, and contradictory. Even high-level constitutional questions remain unresolved. The "division of powers and responsibilities [among Russian Federation members] is as clear as an old-fashioned London fog." In the Russian legal environment, a well-intentioned entrepreneur would have a hard time knowing the relevant rules.

The de facto rules in some instances are informal, reflecting the powers of government authorities. Consider the case of local price controls. Most localities in Russia officially control the prices of only a handful of goods--though often these controls apply to the most important household goods and services, particularly apartment rents, utilities, basic foodstuffs, and local transport fares. But informal restrictions can be much more severe. Threats by a government official to make life difficult for those who don't hold to informal strictures are all that is required. The director of a local anti-monopoly committee noted that he had the power to imprison for up to three years any enterprise manager who ignored his edict--and because he had this power, he had not had to use it, as no one ignored him. In the same locality, the owner of a private bread store indicated that his biggest problem was the "state racket," and the need to keep on the good side of local officials. Local control of commercial real estate provides one important source of official leverage over private businesses. The continuing practice of selling identical goods to different customers at
different prices--with state-sector customers receiving the lowest price--is another indication that some elements of the planning system have outlived the system's formal apparatus.

Taxes provide a fertile area for evasion even in a developed market economy, so it should be no surprise that they offer significant potential for evasion in a transitional economy. Russian tax rules are complex, murky, and frequently evaded. Here is what awaits the foreign investor in Russia with respect to taxes:

"The incoherent and ever-changing tax codes which characterize the current system mean that foreign firms are often unable to calculate even their present tax bills, despite employing large amounts of resources and paying consultants to identify precisely what they owe and where responsibility for taking a decision about tax liabilities ultimately lies. In the event, tax bills are often calculated on the basis of prolonged negotiation with officials from a variety of governmental departments."17

When all relevant taxes are included, rates have been quite high, providing the incentive for underground operation or other forms of evasion--and simultaneously improving the soil for the growth of organized crime. In May, 1995, the chairman of Goskomstat estimated that output hidden for purposes of tax evasion accounted for 20 to 22% of GDP, though even this could be a substantial understatement.18 The Tax Police uncovered 9,000 cases of large-scale tax evasion during the first nine months of 1995.19

Growth of organized crime has been one of the most visible results of the Russian transition. Mafia protection offers the benefit of decreased uncertainty to its clients.20 One set of rules--those involving the enforcement of private contracts, debt collections, and relations with government officials--becomes more standardized, at the cost of increased violence and strong-arm tactics. Those who are caught up in this system would probably prefer a world of government-supplied, inexpensive protection and legal stability, but there is little that they can do about it individually. (Another frequently-employed substitute for public protection, however, is to deal only with those with whom one has strong personal connections.) In this sense they are in a similar position to pre-reform enterprise managers who were required to deal on black markets.21 A survey of Western firms that have invested in Russia indicates that the largest obstacle to FDI is the legal uncertainty; fear of crime or the mafia is a relatively minor concern.22 For many Russian businesses, like most Western firms, security and protection is a standard business expense.

Increased uncertainty about the future during transition tends to reduce effective time horizons. To the extent that breaking the rules entails some risk of a future punishment, including a loss of reputation, individuals will be more willing to run such risks in less stable settings. Similarly, the punishment that accompanies some forms of rule breaking has been undermined during the transition. Corruption, for example, is generally punished by the loss of the official position. As the private sector has grown, however, dismissed state officials have less to lose from corrupt behavior. This assessment seems most applicable to street-level police officers. Police have relatively high-
paying alternatives as private security guards, and their marketability in the private sector cannot
greatly be diminished by previous bribe-taking.

Evasion and Reform

The benefits of evasive activity depend on the quality of the rules that are being evaded. Evasion of the economic restrictions in the planned economy often was socially beneficial, and in many instances even promoted plan fulfillment. In a liberal market economy, however, widespread evasion can be quite detrimental. Present-day Russia has neither a planned economy nor a liberal market economy. Whether evasion currently is offering positive net benefits is impossible to know. Evasion of continuing price controls and excessive government regulation probably improves the economy. Simultaneously, tax evasion contributes to higher inflation and increased uncertainty, and violent criminal activity has a chilling effect on would-be entrepreneurs. Further, an environment of widespread illegality can be unfair, and certainly contributes to a perception of unfairness. Individuals who do well in such circumstances often are those with the fewest scruples about breaking rules.

Evasion of rules in one area tends to induce responses in other areas. For example, the possibility for policemen to earn money through bribes lowers their official salaries. And while firms are evading their legal obligations to the state in tax payments, the state is evading its legal obligations to firms in terms of payments for goods, which in turn is partly responsible for delayed or non-payment of wages, and further tax evasion, etc.

The role that evasion can play in providing an impetus towards efficient policies would seem to be greatly reduced in the transitional economy relative to the planned economy. First, the rules are not nearly so inefficient to begin with, so the marginal social gains from improved rules presumably are reduced. Second, the entrenched bureaucrats have a stake in continuing economic controls, and the ones who remain are those who are particularly unlikely to do well in alternative pursuits. Third, widespread illegality provides fertile ground for politicians to attempt to "get tough on crime," and they may not be very discriminating concerning whether they upgrade the enforcement of "good" or "bad" rules. Nonetheless, the ability to evade rules helps to prevent increased government regulation, and in the case of tax evasion, is leading to simplification and rate reduction in the tax code. In other areas, as well, the potential for corruption serves as a constraint on the amount of discretion that should be given to governmental officials.

4. Further Speculations

"...in several very important respects the development of a backward country may, by the very nature of its backwardness, tend to differ fundamentally from that of an advanced country."

--Alexander Gerschenkron
It is always tempting to judge events in Russia by the standards of developed market economies. Nevertheless, the application of Western standards frequently is misleading, as I have argued elsewhere with respect to barter, monopoly power, and organized crime. The economic outcomes that we see in the U.S. represent the residual of a long evolutionary process of rule-making, individual responses, amended rules, new responses, etc. Policy changes in such near-equilibrium settings then take on the character of, in Prof. Schroeder's famous phrase, a treadmill of reform. Policy makers respond in marginal ways as problems become apparent. Over time, tremendous changes can occur, but primarily they are the result of a relatively slow, evolutionary policy-making process.

The massive reform that Russia is experiencing does not share that character. Rather, the public policy changes, and individual responses, are far from marginal, even as the initial post-Soviet conditions continue to exert enormous influence over the Russian economic and political environment. The value-added tax became operative in 1992 and in 1993 VAT receipts amounted to more than 42% of total government revenues. During the reform period the number of commercial banks has risen from 0 to over 2,500; the number of full-scale private farms from 0 to over 280,000; and over 100,000 state-owned enterprises have been privatized.

With such large changes across a wide spectrum of policy areas, in such a short period of time, it is unsurprising that there have been opportunities to evade the new rules. Privatization offered a very significant, one-time opportunity for evasive activities that included, besides insider machinations to retain control of enterprises, bogus voucher investment funds and counterfeiting of vouchers. In many cases the enforcement of the new policies (such as the VAT) had to start from ground zero. The development of a financial market also presented entirely new types of crimes which Russia had no experiencing policing. Nevertheless, enforcement is beginning to catch up, and an "equilibrium" of sorts is being established. Real wage arrears peaked in July 1994, and one year later had fallen by more than 40%; real inter-enterprise debt peaked in September 1994, and by June 1995 had fallen by nearly 35%. Even officially recorded crime fell nearly 6% between 1993 and 1994. Strengthened resolve with respect to macroeconomic stabilization has also decreased access to legal "loopholes" in tax laws, and limited the subsidies through which localities can sustain price controls.

The "equilibrium" that is emerging in Russia, however, remains far from a U.S.-style market economy. Here is a description of the reforming Russian economy, circa October 1995, from 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.31

The continued entanglement of the government in the economy is quite stifling, and shows
little signs of diminishing. This entanglement is the most important source of the uncertainty over
what the laws actually are—the *de facto* law essentially remains at the discretion of local officials,
upon whom the local judiciary also is dependent.

Relative to the Soviet system, however, the current situation seems to be an improvement.
Certainly there has been a massive increase in private economic activity, despite the barriers of state
and mafia extortion. And the legal norms governing state-private interaction in the U.S. are
inappropriate in the Russian context.32 Of surveyed Russians, 70% do not expect fair treatment
from the state; 45% do not expect fair treatment from grocery stores, either.33 In such
circumstances, perhaps a high corruption equilibrium, where citizens can buy services from
government officials for a bribe in the same way that they can buy bread at the grocers, is not such a
bad outcome.34 There is some evidence that the analogy is not far-fetched: "...Moscow newspapers
list the going rates for whatever ostensibly free government service you may need."35

The transition period in Russia has been marked by radical changes in the official rules, and by
significant individual responses to the new rules—including widespread evasion of the new policies.
A return to a normal policy regime—a treadmill of reforms—might be quite welcome after the
momentous changes of the past few years. With small policy changes and time, state involvement in
the economy can "wither away," to levels more consistent with long-term growth.

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Endnotes

1. In the tax literature, "evasion" involves the illegal contravention of a rule, whereas "avoidance" is a legal circumvention of the rule. Both evasion and avoidance tend to frustrate the intention of the rule, however, and both are important considerations in the design, implementation, and assessment of reform.


3. This discussion echoes Rubin's (1977) analysis of the pressure towards efficiency in common law. Leitzel (1995a) suggests that small-scale evasion of rules is less likely than widespread evasion to promote beneficial policy changes; rather, limited evasion serves as a substitute for such reforms.

4. Grossman (1977) defines the second economy as any activity conducted for private gain, or taken in knowing, non-trivial contravention of the law. A large part of the Soviet second economy, thus, consisted of the legal collective farm markets.


6. Gaddy (1991) finds a negative correlation between official wages and the potential for informal earnings through the workplace, suggesting that in effect planners offered lower official wage rates in those occupations with good opportunities for theft or bribe income. While theft from private individuals was socially frowned upon, theft from the state did not evoke similar negative feelings. Grossman (1977, p. 29).

7. Quoted in Treml (1990, p. 2), from F. Burlatskii, Literaturnaya Gazeta. The fact that Brezhnev apparently engaged in theft represents a slight increase in the amount of theft since czarist times, or an increase in the amount of honest confession. Nicholas I told his son "I believe you and I are the only people in Russia who don't steal." Chalidze (1977, p. 28), citing Yakushkin, Obychnoye pravo (Customary Law), Introduction to Volume 1.

8. In particular, theft from the state received little social sanction, despite higher official penalties for theft of socialist property than for theft of private property. See, e.g., Grossman (1977, p. 29), and Shlapentokh (1989, pp. 90-91).

9. Shmelev and Popov (1989) note that even during the period of War Communism, when private trade in grain could be punished by death, more than half of the grain that reached urban areas did so through private traders. Berliner (1952) documents the extensive informal operations within Soviet enterprises during the Stalin era.


11. This "story" of the demise of Soviet central planning is developed in Leitzel (1995a).

12. The "beach walk" of Shevardnadze and Gorbachev is recounted in Goldman (1992, pp. 83-84).


16. These conversations took place in June, 1995.


18. OMRI Daily Digest, No. 104, Part 1, 30 May 1995. Such a figure reinforces the point that wide-scale evasive activity can lead to significant misunderstandings of actual economic conditions.


21. "The individual, in fact, may have little choice but to fall in with the system of extralegal gain." Grossman (1977, p. 30). Simis (1982) also documents the extent to which illegal behavior was necessary for the smooth functioning of state-sector enterprises. See especially his discussion of Food Shop Number Five, pp. 218-221.

22. Halligan and Teplukhin (1995, pp. 119-121). As noted, this survey involved firms that had already invested. Fears of crime or the mafia might be more important in preventing initial investments.

23. Montias and Rose-Ackerman (1981) distinguish corruption that promotes the goals of the official organization ("organizational corruption") from corruption undertaken for private benefit ("individual corruption"). Whether plan fulfillment actually promoted the welfare of Soviet society is another matter.

24. Even "good" rules, however, benefit from some evasion. Policies are not complete, in the sense that they do not prescribe precise actions for every individual under all possible "states of the world." Rather, rules tend to be quite coarse, and are unresponsive to detailed individual preferences or circumstances. Occasional avoidance or evasion offers an opportunity for improved actions based on more complete information.


27. See, for example, Leitzel (1995b, pp. 41-45, 100-108, 127-130).

28. Figure calculated from Table 4, p. 10, Russian Economic Trends, Vol. 4, No. 1, 1995. Since 1993 VAT has remained the leading source of government revenues, though its contribution to total revenues has declined somewhat in percentage terms.

29. The alternative to official privatization, however, was not the pristine regulation of state-controlled enterprises. Rather, spontaneous privatization that was quasi-legal at best was putting enterprise assets or their associated profit streams in the hands of managers. See Johnson and Kroll (1991).

30. To some degree the declining wage and inter-enterprise arrears may be offset by tax arrears. It should also be noted that reported increases in some crimes may reflect the improved enforcement capabilities, as opposed to an increase in the amount of crime itself.


34. Rose (1995) characterizes Russia as an "hour-glass society," where the top half of the hour-glass is political and social life, and in the bottom half are informal networks of friends and relatives. He characterizes a "significant portion of the electorate" as "actively wanting to protect their well-being by keeping the center of the hour-glass as narrow as possible in order to limit what the state can do to them [p. 41]."