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AUTHOR: MICHAEL ALEXEEV, *Indiana University*

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THE RUSSIAN UNDERGROUND ECONOMY IN TRANSITION¹

Michael Alexeev²

Abstract

Prior to market-oriented reforms the underground economy (UE) profoundly affected all aspects of the Soviet economy. While the UE had both negative and positive effects, on balance it probably made the Soviet system more efficient and improved consumer welfare. Market reforms were supposed to bring UE above ground. Instead, they resulted in its explosive growth. The UE in today's Russia often inhibits the development of competitive markets and causes serious distortions in the economy. After summarizing the developments in the Russian UE during transition I examine the reasons behind this outcome and analyze its implications for the future of reforms.

1. Introduction.

Even prior to the initiation of market-oriented reforms in the late 1980s a great deal of genuine market economic activity took place in the Soviet Union. While some of these markets were legal (e.g. the so-called kolkhoz markets for agricultural goods), many were strictly speaking illegal. Law enforcement, however, was generally lax and the risks of small scale operations in many of these markets were negligible. For example, despite their commonplace occurrence, crimes of "speculation"³ in the 1980s accounted for fewer than 2% of all reported crimes.⁴ According to Kozlov (1990), Soviet researchers believed that only 1% of all crimes of speculation was reported to the authorities. Even this estimate appears to be on the high side.

The Soviet underground economy was not, of course, limited to resale of goods purchased or stolen from official vendors. The illegal economic activities permeated the entire Soviet system. In fact, the official system probably could not have survived for as long as it did without the underground economy's help. Besides greasing the wheels of the official

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²Department of Economics, Indiana University, Bloomington, IN 47405; Tel.: (812) 855-7103; Fax: (812) 855-3736; E-mail, MALEXEEV@INDIANA.EDU.

³Speculation was defined essentially as resale of goods at a profit.

⁴Rossiiskaia (1993), pp. 135-136.

economy and correcting its mistakes, however, the Soviet underground economy was also responsible for significant amounts of waste and distortions. As the official economy stagnated and the illegal sector grew rapidly during 1970s and 1980s, both the productive potential and the negative impact of the underground economy on the rest of the economy were becoming more apparent.

Market-oriented reforms which began, albeit haltingly, in the late 1980s and turned radical in 1992 were in part aimed at bringing the illegal economic activities above ground. Instead, reforms further accelerated the growth of these activities even though the main causes of this growth have changed from price controls to excessive regulation and high tax rates. In today's Russia the underground economy continues to exert both positive and negative influences on the rest of the economy. It appears, however, that in the current environment the negative effects of the illegal sector may have begun to overshadow its positive effects.

This paper is organized as follows. The next section outlines the size and growth of the underground economy in the USSR prior to market-oriented reforms and analyzes its impact on the traditional Soviet economy. A brief description of the major developments concerning the Russian underground economy in the late 1980s and early 1990s is presented in section 3. Section 4 examines the role of the illegal economic activities in the current environment and speculates about their implications for the future of reforms.

2. The Underground Economy in the Traditional Soviet System.

The underground economy has always been an important part of the Soviet system. According to Shmelev and Popov (1989), even during the height of War Communism, when private trade was prohibited and could easily be punished by immediate execution without trial, the black marketeers provided as much bread for the Russian cities as did state procurement. Black markets continued to function during Stalin's period as well. They began to grow particularly rapidly starting in the mid-1960s. By the mid-1970s the underground economy permeated all areas of Soviet economic life.⁵

Comprehensive price controls accompanied by widespread shortages and prohibition of most private economic activities served as the main reasons for the growth of the Soviet black markets. Other incentives for turning to black markets included lack of responsiveness of

⁵Illegal economic activities as well as the so-called second economy in the USSR have been extensively studied by western economists since the pioneering works by Grossman (1977, 1979). According to Grossman's definition, the Soviet second economy included all economic activities which were either performed directly for private gain, or were illegal, or both. The underground economy constituted a major part of the second economy.

official production to consumer demand, high taxation and excessive regulation of the allowed private economic activities, existence of a large amount of impersonal state property kept under inadequate custody, and the need of poorly paid individuals to supplement their incomes.

One of the most common types of illegal activity in the USSR was theft of socialist property (i.e. property of the state, collective farms, "social organizations" such as trade unions, etc.). This type of theft used to be taken for granted by the public and did not provoke serious social disapproval. Even the late Soviet President Brezhnev was quoted as saying to his aides: "You don't know life. No one lives on wages alone. I remember in my youth we earned money by unloading railroad freight cars. So, what did we do? For every three crates or bags unloaded we'd take one for ourselves. That's how everybody in the country lives."⁶ A variant of theft of socialist property was stealing time from work. Apparently, this phenomenon also was commonplace in the Soviet economy. As a reflection of the importance of theft in the Soviet economy, wages in different occupations seemed to be inversely related to the opportunity to steal from the workplace. Trembl (1990) estimated theft of materials from workplaces at approximately 63.7 billion rubles in 1975 and 70.4 billion rubles in 1980, or between 3 and 5% of the Soviet Gross Social Product (defined as the value of output of all material goods, intermediate and final, valued in current purchasers' prices.)

Perhaps just as common was the phenomenon of "speculation" which meant resale of goods for personal gain, and as such was illegal. Despite its illegality speculation was conducted virtually openly. Large markets reminiscent of the American flea markets existed in most large Soviet cities. Officially, their function was to allow individuals to sell unwanted goods, but in reality they became major outlets for selling stolen property, goods produced in the underground economy, and resale of shortage goods purchased at low state-controlled prices.

A significant amount of production by single artisans as well as by entire underground factories also took place in the underground economy. Workers often produced goods on their own account (and on company time) using the equipment at their state-owned enterprise. Many citizens engaged in moonlighting, repairing dwellings and appliances for private customers. Production of moonshine was extremely popular in the countryside.

Such widespread illegal activities in what used to be called a police state could not have been possible without rampant corruption among Soviet officials including law enforcement

⁶Burlatskii (1988), p. 14, quoted in Trembl (1990).

personnel. The existing large literature on this phenomenon makes it pointless to spend time on it here.⁷ A quote from Grossman (1977) presents a vivid general picture:

At the very least one can deduce that the purchase and sale of [official] positions for large sums of money signifies the profound institutionalization in the Soviet Union of a whole structure of bribery and graft, from the bottom to the top of the pyramid of power; that considerable stability of the structure of power is expected by all concerned; and that very probably there is a close organic connection between political-administrative authority, on the one hand, and a highly developed world of illegal economic activity, on the other. In sum, the concept of *kleptocracy*, developed by sociologists with reference to corrupt regimes and bureaucracies in underdeveloped countries, does not seem inapplicable to at least certain portions and regional segments of the Soviet party-government hierarchy (pp. 32-33).

For obvious reasons it is difficult to estimate the size of the Soviet illegal economy. According to estimates based on a Berkeley-Duke survey of emigrants from the USSR, about one third of the urban population's income was derived from the second economy⁸ which employed 10 to 12% of the labor force.⁹ Presumably, the bulk of this income was illegal. Soviet researchers presented a variety of estimates of the illegal economy's turnover ranging from 70-90 billion rubles to as high 300-350 billion rubles in the late 1980s.¹⁰

The dynamics of the underground economy is even more difficult to ascertain. Koriagina (1988) estimated that the second economy had grown approximately 4-fold between the late 1960s and mid-1980s. Trembl and Alexeev's (1994) research based on official retail trade and income data strongly suggested that the second economy was growing rapidly between 1965 and 1985, but they did not arrive at any specific growth estimates.

While one may argue about the precise estimates of size and growth of the Soviet illegal economy, it is clear that by the mid-1980s it was having a major impact on overall economic performance. The illegal economic transactions to a large extent obviated rationing in consumer markets. For example, Alexeev (1988) demonstrated that even though residential

⁷The standard references on Soviet corruption include Simis (1977-78, 1982) and Vaksberg (1992).

⁸Grossman (1987). The estimates relate to the late 1970s. The Berkeley-Duke survey covered 1061 households from urban areas of the USSR. The survey sample contained various biases such as self-selection of the emigres, nationality (most of the respondents were either Jewish or Armenian), and others. These biases, however, did not appear to be large enough to invalidate the reported estimates which are, incidentally, quite conservative.

⁹Trembl (1992).

¹⁰The first estimate is by Koriagina (1988). The second number which was approximately equal to the official retail trade turnover in the USSR is from *Argumenty i fakty*, no. 37, 1989, p. 5. The aggregate official personal income in 1988-89 was roughly 522 billion rubles. Rutgaizer (1992) provides a survey of Soviet research on the second economy.

state-owned housing used to be one of the most strictly rationed consumer goods, and despite the apparent simplicity of rationing of housing, its allocation depended mostly on consumer ability to pay rather than on the proclaimed non-price rationing criteria. Usually redistribution of consumer goods via black markets must have been welfare-improving because it was taking place through voluntary exchanges among individuals. Nonetheless, difficulties with disseminating information and enforcing long-term contracts make the underground economy a less than ideal distribution mechanism. In particular, the need for at least some secrecy, combined with the fact that some black market transactions are more easily concealed than others, result in added distortions in the economy.¹¹ Also, in an otherwise highly distorted economy, the introduction of new markets would not always result in improved welfare. For instance, the possibility of resale in the black market of officially purchased goods can easily lead to longer queues in the first economy relative to the situation when such resale is effectively prohibited.¹² Note, however, that the relatively well-organized nature of corruption in the USSR, reflected in the above quote from Grossman, mitigated some of its negative consequences. When corruption is organized, its immediate effects on economic activity tend to be more like those of taxation, while unorganized corruption may easily result in excessive demand for bribes, thus stifling economic activity.¹³

Besides redistributing goods in consumer markets, the illegal economy was involved in reallocation of inputs and outputs in production.¹⁴ Semi-legal or illegal trades among socialist enterprises often helped these enterprises to fulfill the plan by correcting the initial misallocation of inputs. At the same time, the possibility to divert inputs and outputs to the black market must have worsened the official performance of at least some enterprises. More important, even if the black markets facilitated plan fulfillment, that does not imply that they were good for the economy. From the Soviet consumers' point of view, some state plans probably should have never been fulfilled.

In addition, the illegal economy was partly responsible for weakening and even destroying the feedback from the economy to the planners. When a planner misallocates inputs but the informal trades among enterprises correct this misallocation, the planner has no reason

¹¹ See Shleifer and Vishny (1993) for an example and discussion. This phenomenon is also noted by Leitzel (1995).

¹² See Stahl and Alexeev (1985) for a rather general model of this phenomenon, and Gang and Tower (1988) for a simple example.

¹³ See Shleifer and Vishny (1993).

¹⁴ For a description of the illegal economy in the socialist industry see Grossman (1982).

to change input allocations in the future. In effect, the planners were directing the Soviet economy using a highly distorted picture of the economic situation.¹⁵

The underground economy also played a significant role in altering income distribution in the society. As was mentioned earlier, illegal earnings tended to be inversely correlated with distorted official wages. This does not imply, however, that illegal incomes reduced inequality. Large and highly variable illegal incomes could increase inequality no matter how they related to official incomes. Based on data from the Berkeley-Duke survey referenced above, Alexeev and Gaddy (1993) calculated that the inclusion of illegal income raised income inequality in the Soviet regions with highly developed underground economies.

In addition to affecting resource allocation in the economy, the underground economy was responsible for shaping the image of markets among Russians and provided training grounds for Russian entrepreneurs. In fact, according to one survey, the Muscovites seemed to understand and appreciate the workings of free markets just as well as the residents of New York did.¹⁶ On the one hand, this must have helped to create a consensus for market reforms and promote their progress. On the other hand, underground markets do not adequately reflect the power of legal free markets facilitated by a variety of modern market institutions such as banking and stock exchanges. Perhaps for this reason, the market in Russia often has a bazaar-like image rather than that of a sophisticated mechanism that can coordinate the functioning of a large modern economy.

Finally, one should mention what Cowell (1993) calls "a kind of demoralization crisis" that could be caused by a large underground economy. Illegal economic activities undermine the population's trust in the fairness of the entire system, either socialist or capitalist. The perception of injustice of the economic system is detrimental to welfare by itself even if it is difficult to fit into the more conventional framework of cost-benefit analysis.

3. Perestroika, Market Reforms, and the Russian Underground Economy.

By the mid-1980s the Soviet leadership began to understand the significance of the underground economy. Nonetheless, it exhibited a highly ambivalent approach toward this sector during perestroika. On the one hand, realizing its potential for improving Soviet economic performance the authorities wanted to bring many private economic activities above ground. On the other hand, the leadership was afraid of losing the remnants of control over the

¹⁵Trembl and Alexeev (1994) provide a more detailed discussion of the illegal economy's impact on Soviet economic performance.

¹⁶Shiller et al. (1991).

economy. This ambivalent attitude resulted in a slow and sometimes contradictory relaxation of regulations against private enterprise. Thus, the November 1986 Law on Individual Labor Activity which widened the scope of legal private enterprise in the USSR was preceded by the campaign against "non-labor income" in May 1986. The Law itself provided only a slight relief from the anti-private enterprise regulations. It continued to prohibit many private economic activities, gave regional legislatures broad powers to expand the list of prohibited activities, and required every individual who wanted to engage in individual labor activities to obtain a license from the local authorities.

Throughout the Gorbachev period, the authorities continued to view purely private enterprise with deep mistrust. Instead, they chose to promote family-based and cooperative forms of economic activities. Family-based contractual arrangements in agriculture and family contracts for running some small state-owned service outlets were strongly encouraged by the authorities in 1987 and 1988. A more radical 1988 Law on Cooperatives opened up for individuals many areas of the economy which used to be (at least legally) the exclusive domain of the state.¹⁷ Even this law, however, did not go nearly far enough to bring genuine legal markets into the economy.

The newly permitted cooperative activities were subject to various restrictions. According to the law, cooperatives were restricted in their access to inputs and were not permitted to engage in some important economic activities. Moreover, the state administrative authorities retained the right to exercise significant control over prices charged by producer cooperatives. The local authorities were also allowed to further limit the activities of cooperatives in their jurisdictions. All these restrictions handicapped cooperatives' ability to compete among each other and with state-owned enterprises. Particularly harmful to the goals of reforms were legislative reversals. For example, the December 1988 resolution by the Soviet Council of Ministers prohibited cooperatives from engaging in a number of activities (e.g., medical services) permitted by the original Law. Changes in taxation were especially frequent.¹⁸

Even these half-hearted liberalizing measures resulted in a rapid growth of legitimate non-state enterprises.¹⁹ This growth, however, did not take place at the expense of the shadow economy (to use the Soviet term.) In fact, the partial legitimization of various private

¹⁷*Zakon Soiuza Sovetskikh Sotsialisticheskikh Respublik o kooperatsii v SSSR,* *Ekonomicheskaja gazeta*, no. 24, June 1988.

¹⁸For a detailed discussion of the cooperatives during perestroika see Jones and Moskoff (1991) and Murphy (1993).

¹⁹By 1991 the number of cooperatives in the USSR reached 255,000. They employed almost 6.5 million people producing goods and services worth about 42 billion rubles.

and crypto-private economic activities seemed to spur the development of the underground. According to an estimate of a Soviet researcher, the legalization of about 800 million rubles' worth of the shadow economy in 1988 was accompanied by an increase of 1,400 million rubles' worth of various illegal activities.²⁰

What led to such an outcome? As was mentioned above, some of the actions of the Gorbachev's government contradicted the general direction of reforms. For example, the anti-alcohol campaign launched by the Soviet government in May of 1985 sharply raised prices of alcohol and restricted production of alcoholic beverages by the state. Naturally, this resulted in a dramatic rise of bootlegging and home-brewing. Illegal sales of alcohol reportedly increased by 42% in the first 10 months of 1986. Some Soviet specialists maintained that the reductions in state-controlled output of alcoholic beverages was fully offset by increased production of moonshine.²¹

Ironically, even the more radical measures proved to be counterproductive with respect to their effect on the underground economy. In fact, it was the 1988 Law on Cooperatives which, combined with the 1987 Law on State Enterprise, was probably mainly responsible for the growth of the illegal economic activities during the 1988-1991 period. Prior to the Law on State Enterprise, the Soviet state-owned firms did most of their financial transactions by adjusting the balances of their accounts in Gosbank (the State Bank). Payment of wages constituted the only significant transaction the enterprises conducted in cash. While state-owned enterprises operated under the so-called soft budget constraint with respect to non-cash transaction, the central planners took special care in controlling the wage fund and the cash budget of enterprises in general.²² The separation of the cash and non-cash money flows in the economy allowed the central planners to alleviate the inflationary pressures in the consumer markets.

The 1987 law afforded a large degree of autonomy to state-owned enterprises. In particular, it gave them greater independence in allocating their financial resources without imposing on them serious responsibility for failure. The Law on Cooperatives permitted and even pushed cooperatives and state-owned enterprises into a close business relationship and association. At the same time, state-owned enterprises were allowed to convert their Gosbank account balances into cash for purposes of transactions with cooperatives. This in essence cracked the "wall" between the two types of money flows. The conversion of some non-cash

²⁰This estimate offered by T. Koriagina was quoted in Grossman (1990).

²¹See Trembl (1987) and references therein.

²²The term soft budget constraint coined by J. Kornai essentially means that the enterprises expected to be bailed out by the state virtually automatically if they ran out of money in the non-cash account.

balances into cash heightened inflationary pressures in the economy. In the environment of continuing price controls in the state sector this strengthened the incentives to engage in black market activities and to divert output and non-cash balances from state-owned enterprises into cooperatives and private enterprises. In other words, the conversion of non-cash into cash was a self-promoting phenomenon which generated growth of the black markets. In addition, because diversion of resources from the state sector was usually accomplished through means of at least questionable legality, this diversion itself contributed to a growing share of illegal economic activities.

In general, while the restrictions on private and cooperative businesses might have been imposed in order to combat the diversion of state sector resources, these restrictions only exacerbated disequilibria in the economy helping reduce competition and generate excessive profits thereby promoting corruption and the growth of the underground. Corruption was spurred also by the fact that the Soviet bureaucrats at all levels were in danger of losing many of their traditional privileges either due to marketization of the economy or because of popular discontent. This provided strong incentives to monetize the existing perks and to convert quickly the remaining rents associated with their positions into privately owned assets. Bribe-taking, illegitimate privatization of state-owned assets, sweetheart deals between state-owned enterprises and cooperatives set up by the local bureaucrats, were the most common examples of abuse of official powers. Corruption was further facilitated by the dependence of private and cooperative enterprises on the benevolence of corrupt local authorities which often made entirely legal profitable operations impossible. At the same time, the permission in principle of private and cooperative enterprise provided an ideal front for expanding the scale of the traditional illegal economic activities, and created opportunities for new ones. For example, the establishment of commercial banks presented previously virtually non-existent opportunities for bank fraud.

Another important obstacle to legalization of the underground economy was the black marketeers' mistrust of the Soviet government's commitment to market-oriented reforms. In the absence of such commitment private entrepreneurs were afraid to reveal themselves and the extent of their operations. Such fears were supported by significant reversals in the progress of reforms and by the existence of many old anti-entrepreneurial laws on the books.²¹

²¹Thus, the blanket prohibition of "speculation" was not repealed until January 1992. Litwack (1991) and Boettke (1993) discuss the importance of credible commitment by the government for the success of reforms.

4. The Underground Economy in Reforming Russia.

The eventual acceptance in principle of the market economy came with the breakup of the USSR in late 1991. Since the 1992 reforms the Russian economy has no longer been planned from the center in the conventional sense of the word.²⁴ However highly regulated the contemporary Russian markets are, the Russian economy is supposed to be governed mainly by market forces. Nonetheless, a large and perhaps growing share of the economy continues to operate underground. The flourishing illegal economy in today's Russia owes its existence essentially to the same factors as in the traditional Soviet economy, although the relative importance of these factors has changed dramatically. Tax evasion appears to have become the main reason for operating businesses underground, while price controls, various regulations, and the remaining prohibitions on private economic activities have become less significant.

To the extent that the Russian economy suffers from excessive regulation, the role of black markets in contemporary Russia resembles their role in the traditional Soviet economy. On the one hand, black markets help entrepreneurs get around onerous regulations, thus enhancing the overall economy's performance.²⁵ On the other hand, underground enterprises face difficulties with disseminating and acquiring information, and with contract enforcement.

In some important respects, however, the role and impact of the underground economy in Russia now differ significantly from those in its Soviet counterpart.

First, reforms brought with them an unusually high amount of uncertainty about property rights and about the future of the entire system. The admittedly inefficient and restrictive traditional Soviet system was in many ways more predictable. The elite could count on keeping their privileges through their old age, while ordinary consumers expected prices to remain low and shortages to persist. The system was relatively stable. Even the underground economy enjoyed a large measure of stability which allowed the black marketeers to plan for the future and put premium on reputation. The volatility and turmoil brought about by radical reforms reduced the present value of following the rules, thereby promoting growth of the underground. Moreover, the uncertainty about the future undermines incentives for black marketeers to develop and maintain reputations for high quality of their services. The generally high level of volatility in the economy not only facilitates illegal economic activities, but also shortens the time horizon of the agents operating underground, making them likelier to cheat.

²⁴One might argue that the Soviet economy was not really a planned economy even prior to reforms (see, for example, Zaleski, 1980 and Roberts, 1990). Whether we call it central planning or not, however, commands from the center used to play a significant role in the functioning of the Soviet economy.

²⁵In the words of Cowell (1993), "a world of perfect enforcement could be an intolerable place."

Second, growth of the underground economy reduces the tax base, promoting inflation and forcing the government to increase the tax burden on legitimate enterprises. Rising tax rates push even more businesses underground which leads to still higher tax rates, and so on. Reduced tax revenues lead the government to print money imposing inflation tax on its subjects. Inflation, in turn, creates greater uncertainty with all its negative implications.

Third, the underground economy attracts and promotes organized crime.²⁶ Organized crime or mafia might play a positive role in the economy, for example by helping enforce contracts and maintain order in the underground economy, or in other circumstances when legal enforcement is not forthcoming.²⁷ The Mafia, however, may impose serious costs on the economy as well. To begin with, some potential entrepreneurs may not want to deal with the mafia on moral grounds (or just as a matter of taste). If the only way to run a successful business is to pay protection money to organized crime, these entrepreneurs would not even bother to start up.

Another problem with organized crime's involvement in the economy is its tendency to favor monopoly. It is interested in maximizing rents, and rents are maximized if a firm has a monopoly. For example, having one restaurant in a district may bring significant rents. If competition from other restaurants is allowed these rents would be reduced, and criminal elements may use force to prevent other restaurants from opening up.²⁸

In addition, a larger monopoly establishment may be easier for organized crime to monitor than several small firms. A similar argument was commonly used to explain the Soviet planners' preference for building large enterprises which often enjoyed a monopoly position in their segments of industry. This advantage of the monopoly is somewhat offset, though, by the fact that competition facilitates monitoring by providing a standard of comparison.²⁹

Finally, a monopoly might be less likely to complain to the authorities if organized crime shields it from competition and leaves it at least a small portion of the monopoly rents.

²⁶According to a recent Russian government report 70-80% of private enterprises in major cities were paying protection money to organized crime (*New York Times*, January 30, 1994, p. 1.)

²⁷For an insightful discussion of the economics of organized crime see Schelling (1984). The costs and benefits of the mafia in the Russian economy in transition are examined in Leitzel et al (1995).

²⁸This argument works if the organized criminal group itself is running the restaurant. If, however, a criminal group controls the district and can collect fees from establishments located in it, the group may be able to raise the more revenues by allowing multiple sources in competition.

²⁹In more technical terms, competition eliminates the common uncertainty facing the firms' management, leaving only firm-specific uncertainty to influence its performance (see Holmstrom, 1982). Lower uncertainty leaves less room for the management of the firm to hide its true productive potential from the shareholders (or from the mafia).

Organized crime is not, of course, new to Russia. In many ways the traditional Soviet nomenclature resembled an organized crime group, particularly with respect to illegal economic activities that took place in the USSR. (See the quote from Grossman's study in section 2.) The nomenclature used to hold a virtual monopoly on rent extraction from both legal and illegal sectors of the Soviet economy. The underground entrepreneurs usually had to pay off government officials and law enforcement officers in order to stay in business. In this sense, the current situation is distinguished by a higher degree of competition among the criminal groups and greater "disorganization" of the rent extracting mechanism.³⁰

Despite the changing nature of the Russian underground economy, it could be argued that the current situation is an improvement over the past in that a regulated market economy, together with the underground economy, other things being equal, would perform better than the traditional Soviet system together with its underground economy. While illegal economic activities exert essentially the same ambiguous influences on the rest of the economy, the more market-oriented nature of the legitimate economy should hold an advantage over central planning.³¹ The net impact of the black markets on the Russian economy, however, probably has changed, on balance, from efficiency-enhancing under central planning to detrimental during transition to markets. Presumably, even an excessively regulated market economy would perform better if it is largely legal than if much of it is underground.

What are the implications of the existence of the large Russian underground economy for evaluating the progress of market reforms and for the likelihood of their success? The difficulties with measuring illegal economic activities and incorporating them into the system of national accounts distort our perceptions of both the pre-reform and the current situation. If the Russian underground has been growing rapidly over the last several years, then the official data on economic growth underestimate the performance of the Russian economy. Such bias is particularly dangerous in the present volatile political situation. Perception of the economic failure of reforms can easily become self-fulfilling by, among other things, weakening the monetary system, further increasing uncertainty, and driving even more entrepreneurs underground. The perceived link between reforms and economic crime provokes calls for limiting the freedom to engage in private economic activities and for other restrictions on

³⁰The relatively disorganized nature of the organized crime currently is evident from government data indicating that less than 1% of the 4000 "organized criminal groups" in Russia consisted of more than 10 individuals. More than half had only 2 or 3 members (*Statistika sotsial'nykh anomalii*, p. 19.)

³¹I do not want to take this argument too far. For example, the Soviet state might have been much more efficient at extracting rents from the underground economy while the contemporary mafia may do it in a wasteful manner.

individual rights. If reforms become too closely associated with the illegal economy the fight against crime may lead to serious reversals of reforms.³²

The underground economy modifies the effect of reform measures directed at the official economy. For example, an increase in tax rates may generate greater revenues for the government if the black markets are underdeveloped. They may, however, reduce revenues sharply if the underground economy presents a viable alternative for the entrepreneur.³³ In order for their policies to achieve the desired effects, the Russian reformers should always try to take into account the existence of the large illegal sector in Russia. Indeed, it might be precisely the realization of the limits of their power in the face of the underground economy that prevents the current government from imposing even more regulations and higher taxes on businesses and individuals.

The reformers should also realize that the problems posed by the large and growing underground economy and economic crime cannot be solved by tightening regulations and increasing taxes. On the contrary, it is the reduction of tax rates and the removal of most constraints on legal private activities that can bring much of the illegal economy above ground and improve the performance of the Russian markets. Because organized crime thrives on illegal economic activities, this would also reduce the role and power of the Russian mafia. The solution to the problem of economic illegality in Russia lies in the continuing advance of free market reforms.

³²A more comprehensive discussion of the relationship between economic crime and reforms can be found in Alexeev et al. (1995).

³³The rollback of cigarette taxes in Canada in 1994 provides a vivid example of the government recognizing the economic power of the underground.

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