

UNDERGROUND ACTIVITY AND INSTITUTIONAL CHANGE: PRODUCTIVE, PROTECTIVE AND PREDATORY BEHAVIOR IN TRANSITION ECONOMIES

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ABSTRACT

This paper examines why some transitions are more successful than others by focusing attention on the role of productive, protective and predatory behaviors from the perspective of the new institutional economics. Many transition economies are characterized by a fundamental inconsistency between formal and informal institutions. When formal and informal rules clash, noncompliant behaviors proliferate, among them, tax evasion, corruption, bribery, organized criminality, and theft of government property. These wealth redistributing protective and predatory behaviors activities absorb resources that could otherwise be used for wealth production resulting in huge transition costs.

Noncompliant behaviors--evasion, avoidance, circumvention, abuse, and/or corruption of institutional rules--comprise what we can be termed underground economies. A variety of underground economies can be differentiated according to the types of rules violated by the noncompliant behaviors. The focus of the new institutional economics is on the consequences of institutions--the rules that structure and constrain economic activity--for economic outcomes. Underground economics is concerned with instances in which the rules are evaded, circumvented, and violated. It seeks to determine the conditions likely to foster rule violations, and to understand the various consequences of noncompliance with institutional rules. Noncompliance with "bad" rules may actually foster development whereas non compliance with "good" rules will hinder development. Since rules differ, both the nature and consequences of rule violations will therefore depend on the particular rules violated. Institutional economics and underground economies are therefore highly complementary. The former examines the rules of the game, the latter the strategic responses of individuals and organizations to those rules. Economic performance depends on both the nature of the rules and the extent of compliance with them.

Institutions therefore do affect economic performance, but it is not always obvious which institutional rules dominate. Where formal and informal institutions are coherent and consistent, the incentives produced by the formal rules will affect economic outcomes. Under these circumstances, the rule of law typically secures property rights, reduces uncertainty, and lowers transaction costs. In regimes of discretionary authority where formal institutions conflict with informal norms, noncompliance with the formal rules becomes pervasive, and underground economic activity is consequential for economic outcomes.

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“The more corrupt the state, the more numerous the laws.”
Tacitus History, III c. 100

“Laws like cobwebs, entangle the weak, but are broken by the strong.”
Ascribed to Solon c. 575 B.C.

INSTITUTIONS AND ECONOMIC PERFORMANCE

North (1990) has persuasively argued that institutions matter insofar as they affect economic outcomes, but we still lack an explicit formulation of the critical relationship between institutional arrangements and economic performance. From the perspective of economic history, the institutional change that shapes the evolution of societies is seen as “overwhelmingly incremental” and highly “path dependent.” How then, are we to reconcile this “glacial” view of institutional change with the radical transformations now under way in Central and Eastern Europe and in the New Independent States (NIS) of the former Soviet Union? Are these revolutions less revolutionary and less discontinuous than they appear? What will ultimately determine their outcomes? North (1990: 91) suggests that the outcomes of revolutionary changes will depend on “the ongoing tension between informal constraints and the new formal rules.” Formal institutions have indeed changed radically in the former Soviet Union, but informal institutions much less so. What then can we learn from a closer examination of the informal conventions, particularly when these include norms of noncompliance with the formal rules?

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This paper attempts to identify some of the critical components of the institutional matrix that motivates behavior, the types of behaviors most likely to affect economic performance, and the complexity of the relationship linking the two. They provide us with valuable hints as to where we must look to discover just how institutions determine economic performance.

The historical laboratory of the transition economies has revealed that liberalization, stabilization, and privatization may be necessary but are by no means sufficient conditions for creating “market economies.” Every market presupposes the existence of property rights to be traded. When these rights are established, supported, and enforced in a transparent, even-handed manner under the rule of law, the transaction costs of exchange are significantly reduced, and economic outcomes are likely to be improved. Many of the transition economies have yet to establish the rule of law, and suffer instead from the legacy of regimes of arbitrary discretion that encouraged noncompliant behavior as the informal norm.

If we are to understand why some transitions have been relatively rapid and successful while others have languished and suffered from huge adjustment costs, we must examine how each society has structured the relative incentives for productive, protective, and predatory behaviors. These incentive structures are unlikely to be transparent, particularly when there is a lack of coherence between formal and informal institutions. When formal and informal institutions clash, noncompliant behaviors proliferate, among them, tax evasion, corruption, bribery, organized criminality, and theft of government property.

Many of the centrally planned economies suffered from fundamental inconsistencies between formal and informal institutions. Consequentially, the transition process had to deal with a legacy of noncompliant behaviors involving protective and predatory activities. One of the great challenges for a successful transformation is determining how to restructure institutions and incentives so that resources are redirected toward productive outcomes.

PRODUCTION, PROTECTION, AND PREDATION

Societies allocate scarce resources to produce, protect, and redistribute wealth. A nation's growth--its ability to produce new wealth--will be determined by its technology, the quality and quantity of its total resource endowment, and the amounts of resources employed in the protection and redistribution of existing wealth. Those resources not devoted to protective and acquisitive activities can be allocated to the production of new wealth.

As the administrative mechanisms of central planning give way to market allocations, and state ownership is replaced by private property rights, economic behavior is guided by a radically altered system of incentives, sanctions, and opportunities. Given these new institutional rules, individuals and organizations must make strategic decisions about the allocation of their scarce resources among productive, protective, and predatory activities. We might conjecture that the most constructive form of institutional change is that which provides incentives to direct resources away from protective and acquisitive activities and toward productive ones.

Production costs reflect the transformation of inputs into outputs. Transactions costs are associated with the acquisition, protection, and transfer of property rights. The linkage between institutions and economic performance depends critically on the incentive structures that flow from property rights. Efficient institutions provide incentives to minimize the sum of production and transaction costs. When property rights are uncertain and insecure, difficult to measure and monitor, costly to enforce, and inconvenient to trade, transaction costs are high, and considerable resources must be employed for the protection and redistribution of wealth. Conversely, when institutions are successful at reducing these transaction costs, resources are freed to enhance economic performance.

Institutions generate and enforce rules of behavior and rules of procedure. Rules of behavior structure incentives and constraints on permissible activities; rules of procedure specify acceptable means for amending and modifying the existing rules. Institutional change can occur in either a prescribed or a proscribed manner. Prescribed institutional change is in accordance with a society's rules of procedure, whereas proscribed institutional change comes about when

behavioral and procedural rules are broadly violated. Noncompliance with formal rules changes institutions. Prescribed change is typically smooth and gradual, whereas proscribed change, resulting from noncompliance with existing rules, typically appears to be traumatic and radical.

Underground economies are characterized by noncompliant economic behaviors involving evasion, avoidance, circumvention, abuse, and/or corruption of the rules, as well as accompanying efforts to conceal these illicit behaviors from the view of public authorities. Noncompliance is responsible for many of the unintended consequences that often result from policy reforms. The effort to conceal underground activity systematically distorts conventional information systems and thereby complicates efforts to observe and monitor the consequences of policy reforms. These consequences and the way they are perceived thus depend in large measure on the extent to which individuals and organizations comply with the new rules. The choice to comply or not depends on the relevant incentives and sanctions and is often conditioned by the institutional structure that prevailed in the pre-transition period. Therefore, institutional change is likely to be path dependent.

When rules are circumvented by widespread noncompliance, economic performance is likely to be powerfully affected. Since institutional change is the defining feature of transition economies, any inquiry into the causes and ultimate consequences of the transition must include an analysis of the incentives and sanctions governing various types of underground economic activities. Indeed, the perception, nature, and consequences of noncompliant behaviors depend on the particular rules being violated. Any analysis of institutional change in the context of transitional economies must address the consequences of noncompliant behavior as manifest in different underground economies. These include the widely observed occurrences of bribery, corruption, organized crime, financial scams, tax evasion, property theft, smuggling, money laundering, and extortion.

Formal and Informal Institutions

Institutions represent the rules that constrain human behaviors by affecting the expected payoffs for economic actors. But there are many types of institutions, spanning formal legal systems and informal customs and norms. Particularly in times of social transformation, the rules of different institutions may be discordant. Eggertsson (1997) points out that “the primary weakness of the economics of institutions is its limited understanding of the amalgam of formal and informal rules and their attendant enforcement mechanisms.”

When the institutional amalgam is hierarchical, consistent, and complementary, we most easily discern effective rules by studying their codification in formal institutions. Coherence between formal and informal norms simplifies the task of defining and enforcing acceptable behavior. Compliance with the existing institutional rules is the dominant behavior.

When formal and informal rules are inconsistent or in conflict, the effective rules germane to economic performance will depend on the extent to which individuals and organizations comply with the formal rules. Observation of widespread noncompliant behavior signals a formal system in distress. The study of noncompliant behaviors (underground activities) and the incentive structures that induce these behaviors provides a powerful diagnostic tool for identifying which informal institutions effectively motivate relevant economic outcomes. Leitzel (1997) points out that “while evasive behavior complicates the effort to analyze the impact of policies, it can promote reform” by attracting the attention of policy makers, who can then either increase enforcement or legitimate the noncompliant behavior through liberalization of the rules.

Noncompliant Behaviors

Changing incentive structures affect the relative costs and benefits of complying with a newly evolving system of rules. Noncompliant behaviors--evasion, avoidance, circumvention, abuse, and/or corruption of institutional rules--comprise what we can be termed underground economies. A variety of underground economies can be differentiated according to the types of rules violated by the noncompliant behaviors.

Noncompliant behaviors are often the source of the unintended consequences observed in the aftermath of policy reforms. Moreover, since such behaviors are subject to penalties, rule violators will attempt to conceal them from public view. Successful concealment distorts information and hinders our ability to perceive and interpret correctly the outcomes of policy reforms.

Radical institutional reform often creates a climate rife with noncompliant behaviors. The extent, nature, and consequences of underground economic activity will affect the impact of institutional change on economic outcomes. The study of noncompliance in transition economies is likely to yield the most revealing view of the effective prevailing incentive structure, of the critical strategic behaviors induced by that structure, and thus of the outcomes of policy changes.

Institutional Economics and Underground Economics

The focus of the new institutional economics is on the consequences of institutions--the rules that structure and constrain economic activity--for economic outcomes. Underground economics is concerned with instances in which the rules are evaded, circumvented, and violated. It seeks to determine the conditions likely to foster rule violations, and to understand the various consequences of noncompliance with institutional rules. The greater the expected net benefit from noncompliance, the higher its expected incidence. Since rules differ, both the nature and consequences of rule violations will depend on the particular rules violated. Institutional economics and underground economics are therefore highly complementary. The former examines the rules of the game, the latter the strategic responses of individuals and organizations to those rules. Economic performance depends on both the nature of the rules and the extent of compliance with them.

There are, of course, as many noncompliant activities as there are rules to be violated. Feige (1990a) has shown that underground economies comprise similar types of noncompliant behaviors. For example, when fiscal rules are violated, tax evasion and benefit fraud behaviors

are said to comprise the *unreported economy*. As suggested earlier, rule violators, mindful of penalties, will typically seek to conceal their behavior from public authorities. When income-producing activities are concealed and thus cannot be appropriately included in national income accounts, accounting conventions are violated, creating an *unrecorded economy*. Those activities involving the abuse of public office for private gain constitute the *corruption economy*. More generally, those activities that violate the rules prohibiting extortion, financial fraud, smuggling, organized crime, and theft of state property are examples of *illegal economy* activities.

Consequences of Noncompliance

There is a growing literature expressing concern about the prevalence of illegal activities and their corrosive effects. However, Leitzel (1997) reminds us that, as noted above, the consequences of various noncompliant behaviors depend critically on the nature of the rules being violated. The violation of “bad” rules--“those that prohibit voluntary exchanges--in the absence of negative third party effects”-- may actually have positive economic consequences.¹ De Soto (1989) argues that noncompliant behaviors that circumvent onerous regulations in developing countries effectively reduce transaction costs and therefore should be encouraged and legitimated. Corruption can also be viewed as a means of circumventing bureaucratic obstacles with "speed money," and even organized crime has been cited as a means of providing enforcement of property rights when the state is weak and ineffectual.

The evasion, circumvention, and violation of “good” rules--those that prohibit and regulate coercive behaviors-- are likely to make society worse off. In the parlance of institutional analysis, whenever noncompliance increases uncertainty and the costs of measuring and monitoring behavior, it raises transaction costs and is likely to have damaging social consequences. Indeed, the weight of the evidence appears to be shifting in the direction of

¹ Similar arguments can be found in Leff (1966) and Huntington (1968).

uncovering the long-term damage that result from pervasive noncompliance, particularly in the form of corruption and organized crime. Bribery and corruption often encourage the bureaucracy simply to create additional artificial administrative hurdles in order to receive side payments for their removal. At the same time, organized crime and corruption are seen as a growing menace to new business establishments and as a major barrier discouraging foreign capital investments.

The extent of noncompliance is also an important factor when threshold effects dominate the dynamics of institutional change. Low levels of noncompliance with bad rules might provide a useful buffer against the negative effects of the bad rules, but widespread noncompliance can undermine the social fabric and erode political legitimacy, thereby jeopardizing the fundamental principle of the rule of law.

There is now an ongoing debate (see Grossman, 1989; De Soto, 1989; Klitgaard, 1991; Leitzel et al., 1995; Trang, 1994; Alexeev, 1997; Lotspeich, 1995; Shelley, 1995; Tanzi, 1994; Anderson, 1995; and Mauro, 1995) concerning the consequences of various types of noncompliant behaviors. Analysis of noncompliance under the Soviet regime suggests that the circumvention of price and production controls contributed to a more efficient system and served to buffer some of the most costly consequences of allocation by administrative control. The buffer function may have extended the lifetime of the Soviet regime by ameliorating some of the costs of misallocation. But, as discussed below, the pervasiveness of noncompliance under the Soviet regime has had a pernicious effect on subsequent economic reforms.

The Legacy of Noncompliance

If we are to understand the severe adjustment costs sustained during the transition process, particularly in the NIS, we must examine the institutional structure of the earlier Soviet regime and the legacy of noncompliant “second-economy” behaviors induced by its perverse incentive systems (Grossman, 1977). The Soviet Union’s criminal code prohibited most of the private economic activities regarded as normal in Western market economies. Despite heavy

penalties, however, noncompliance with the formal laws was the rule rather than the exception. Handleman (1995:275) describes the Soviet Union as the “world’s most heavily policed state.” Yet paradoxically, it functioned as an essentially lawless society.

Grossman (1992:220) has pointed out that if one were to attempt to characterize the conditions likely to “maximize the scope and size of a country’s underground economy,” one would effectively describe Soviet-type socialism. A shortage economy with state-controlled prices well below black market prices created significant incentives for internal arbitrage and speculation. Similar gaps between world prices of tradables and controlled domestic prices encouraged international smuggling. The prevalence of amorphous property rights and lax controls over state assets made the theft of state assets a pervasive predatory activity. Low administrative salaries combined with powerful governmental authority created rent-generating opportunities for bribery and corruption to flourish. In short, the economic incentives to engage in economic crimes were substantial, but so were the penalties.

Feldbrugge (1989) describes how the formal legal system treated economic crimes. Economic activities regarded as normal in market economies not only were prohibited under Soviet law, but also carried heavy penalties. Private enterprise and commercial middleman activities carried a maximum penalty of 5 years in prison, while speculation drew a 7 year term. Bribery and theft of state property were punishable by 15 years’ imprisonment and death. Despite this stiff menu of punishments, these activities were commonplace, and indeed virtually necessary to maintain minimum living standards.

In fact, economic crimes were broadly tolerated by the Soviet regime. They served to buffer the economy from the misallocation failures of the administrative system, and acted as a means of enforcing strict political control. Tacit permission to engage in economic crimes served as a means to reward the *nomenklatura* and its clients, while the arbitrary threat of enforcing the law provided a means of maintaining strict control over political dissent.

Noncompliance with the rules was so pervasive that illegal activities comprised a vast underground economy known as the second economy. Virtually every citizen was a de facto

criminal by dint of engaging in one or more common economic crimes. Citizens were reinforced in the expectation that no punishment would be exacted if one complied with the strict codes for appropriate political behavior. These included informal conventions signaling the extent to which different levels of the political hierarchy could dip into the pot of forbidden economic riches. Permitting a pervasive underground economy served as a means of controlling political dissent, rewarding elites, and buffering the hardships imposed by the inefficiencies of central planning. The resulting regime of arbitrary discretion was the antithesis of the rule of law.

The Rule of Law and the Regime of Arbitrary Discretion

Under the rule of law, conduct is governed by formal statutes and judicial agencies that offer and deliver access and equal protection to all citizens. Institutional control is exercised by the even-handed application of formal rules. The norm for behavior is compliance with the rules. When the rules are violated, a credible system of effective punishment of violators comes into play. Thus control is based on “the application of the law.”²

Under the Soviet regime of arbitrary discretion, most common conduct was prohibited by formal law, but enforced capriciously at the discretion of those in authority. Access to the system’s institutional rewards and protections was reserved for the privileged few, but even then remained uncertain and uncontrolled by law. The norm of behavior was noncompliance with the rules. Penalties were assessed only rarely, and then only at the discretion or whim of the privileged elite that held effective power. Control was based on infringement of the rules, and involved both the carrot and the stick. The carrot consisted of granting the *nomenklatura* use rights over scarce resources, whereas the stick consisted of the threat to exact punishment for the commission of economic crimes.

² In describing the prereform Hungarian system Gabor (1989:347) distinguishes between “control based on the application of rules and “control based on the infringement of rules.”

Implications of the Legacy of Noncompliance

The regime of arbitrary discretion was the legacy and operative institution that survived the collapse of communism. Polishchuk (1997) ascribes some of the lack of progress in Russian reforms to the “institutional void” characterized by “missing markets.” But the formal “institutional vacuum” was in fact filled with dominant informal rules that defined de facto property rights and incentives that guided resource allocation in the second economy. Rent-seeking, rent-creating and, rent-exploiting activities were pervasive.

In the transition period, policymakers hoped that “organic growth” would produce the political and economic institutions needed to support market activities, essentially leaving the market to create the market. But this policy of benign neglect failed to produce the desired rule of law. This was due not only to the lack of a broad constituency for building market-supporting institutions, but also to the inertia of the informal norms of noncompliance.

When reforms did occur, they often legitimated the system of noncompliance that was already in place. World Bank (1996) estimates of unofficial activities suggest that in a sample of Central and Eastern European countries, the underground economy increased from 18 to 22 percent between 1989 and 1994. For a sample of NIS countries, the underground economy appeared to grow from 12 to 37 percent during the same period. Increased noncompliance was associated with weakened political controls, higher tax rates, and incomplete liberalization.

Liberalization served to legitimate the pervasive black markets by legalizing speculation and arbitrage. The freeing of prices conferred market value on many of the inventories accumulated as illegitimate wealth stocks under the Soviet regime. The creation of internal and external ruble convertibility and the liberalization permitting the accumulation of co-circulating foreign currencies legitimated illegal stores of monetary wealth. Thus the reforms simply legitimated much of the behavior that had already existed in the pre-transition period. In this sphere, the revolution was less than revolutionary and proved to be highly path dependent.

Privatization legitimated the personal appropriation of state property by placing previously amorphous property rights to state assets directly in the hands of private actors.

Privatization created the opportunity for privileged elites with information and network advantages to convert limited de facto use and income rights into more valuable de jure alienable rights. Not only did privatization legitimize de facto property rights, but it offered a huge incentive to allocate resources to protective and acquisitive activities. The preference for predation over production was tied to the opportunity to capitalize long-term income streams by obtaining de jure alienation rights.

The uncertainty associated with tentative property rights also encourages appropriation of state property and discourages the type of productive investment that would normally be associated with longer economic horizons. The expected rewards from rent-seeking activities simply dwarf the expected returns from productive activities. Rent seeking will continue to dominate as long as there are valuable unassigned property rights in the public domain, still available for privatization.

The legacy of noncompliance inherited from the pre-transition period was accompanied by a pervasive distrust of government. A history of policy reversals and arbitrary confiscations had destroyed the credibility of government pronouncements and policies. Thus, the informal norm of distrusting government policy militates against every effort to establish the formal rule of law. In the absence of effective state institutions that can protect and enforce newly created property rights, these rights will remain uncertain and their exercise will involve high transaction costs.

In this effectively stateless and lawless environment, organized crime can provide a locus of authority for contract enforcement and the adjudication of contested property rights. Thus, organized crime performs a substitute enforcement service that reduces uncertainty, albeit at a high social cost. Unfortunately, the economies of scale that normally accrue to legitimate governmental institutions now accrue to the mafia. Those public officials that retain the bureaucratic power to assign remaining public-domain property rights will continue to exploit their authority, reinforcing the legacy of corruption.

Although tax evasion existed in the pre-transition period, most taxes were collected implicitly by paying labor less than the value of its marginal product and by limiting the consumption of goods and services. In market-oriented economies, resources are paid the value of their marginal product, and taxes are subsequently collected explicitly on resource earnings. When liberalization eliminated price controls for goods and factors, the implicit tax revenue collection mechanisms collapsed, and the state suffered a significant loss of revenue, which in turn bloated budget deficits. These deficits could be financed either by creating money or by borrowing from the public. Printing money to finance the deficit simply fueled inflation and compounded the disruptive effects of the transition. It eroded the fixed incomes of the working poor and pensioners, and disguised the relative price signals of the fledgling market economy with shocks to the general price level.

The legacy of distrust of government also precluded the government from financing its deficit with the sale of public debt. In desperation, the government embraced the same informal convention of nonpayment that had been adopted by large firms. Nonpayment by firms created inter-industry arrears. When the government refused to make payments for wages and pensions, it effectively forced an unwilling public to accept government debt in the form of government expenditure arrears.

Another legacy of the pre-reform system was a highly skewed distribution of wealth and information. Although incomes were distributed quite equitably, differential access to state resources and selective opportunities for illegal wealth accumulation created a highly unequal distribution of de facto property rights. The opportunity to convert and capitalize these de facto rights into de jure rights created a small but powerful constituency for selective privatization, but not necessarily one that would support generalized property rights.

Corruption is perhaps the most troubling legacy of the pre-transition period, and threatens the dynamic stability of the transition process. Corruption occurs at the juncture where public and private sectors meet. When public officials are granted authority to license, prohibit, tax, or subsidize economic activities, allocate favorable exchange rates, enforce trade restrictions or

price controls, distribute valuable property rights and natural resource endowments--monopoly powers are created in the public domain. Corruption is a form of government failure that occurs when public officials, acting as the agents of the state, exploit the state's monopoly powers for their personal advantage. Corruption involves noncompliance with the rules governing appropriate conduct in public office.

The extent of noncompliance will depend upon the expected gains and penalties which according to Klitgaard (1988) are determined by the monopoly power to be exploited, the extent of discretion granted the agent of the government and the degree to which the agent is held accountable. The economic cost of corruption depends not only on its extent, but also on its nature. Shleifer and Vishny (1993) present an industrial organization model of corruption that shows that corruption is less costly when it is controlled by an effective cartel, like the rule of arbitrary discretion imposed by the Communist party in the former Soviet Union. In this case, payment of a bribe is sufficient to assure the predictable transfer of the scarce property right and the bribe price is kept in check. The most costly form of corruption occurs when independent monopolists vie for bribes. This model best describes the current situation in the NIS, where corruption is omnipresent, yet property right transfers remain uncertain and unpredictable even after bribes have been paid. With vast, highly prized property rights in the public domain, controlled by independent monopolists whose actions are unconstrained by accountability and the rule of law, predation dominates production with devastating economic consequences.

Building a Constituency for the Rule of Law

The legacy of noncompliance with formal rules and the concomitant distrust of public policy have resulted in great resistance to the necessary establishment of the rule of law to support and complement the still fragile property rights and market institutions of the transforming economies. The earliest privatization schemes proposed to transition governments attempted to build a powerful constituency for reform institutions by creating a massive class of private shareholders (Feige, 1990b, 1990c). Privatization had to be demanded by the populace

for there were no institutions to coerce citizen participation. It was hoped that the creation of a new egalitarian base of holders of residual property rights would produce a political lobby to establish and protect property rights as well as political pressures to improve corporate governance structures. These structures, in turn, would maximize the value of the residual property rights themselves. In addition to these incentive effects, it was hoped that the equitable distribution of valued assets would serve as a safety net to cushion the inevitable decline in other government support programs.

Polishchuk (1997) argues that this program failed in its first goal, “to prevent the rapid growth of inequality and to compensate for the loss of private savings to inflation,” while it is still unclear whether the program has helped to build a constituency to protect property rights. In Russia, the scale of the privatization program was massive, creating a class of 50 million shareholders.³ Nevertheless, the failure to include “anti-carpetbagger” provisions (see Feige (1990b) to protect the residual property rights of the poorly informed public permitted wealth holdings to become even more highly skewed. Russian enterprise insiders obtained, on average, two-thirds of the mass privatization shares. By 1996, “all employees owned an average of 58 percent of the stock.” (Blasi, et. al (1997:54). Although a key objective of the privatization program was to break the dependency linkage between enterprise managers and politicians, “the tie proved more durable than many observers had believed or hoped.” Blasi et. al. (1997:38)

SUMMARY

³ Nellis (1996) reports that by the end of 1994, the 15 transition countries of Central and Eastern Europe and the NIS privatized more than 30,000 large and medium-sized firms. In Russia, 16,000 large and medium-sized firms and 75,000 small business were privatized. However, an estimated 10,000 large and medium-sized firms are as yet not privatized. Blasi,et.al. (1997:26) report that by the beginning of 1996, “77.2 percent of mid-sized and large enterprises were privatized.” Moreover, some 900,000 new small businesses were established representing 82 percent of shops and retail stores employing 9 million people. Yet of 67 million employed Russians, “no more than 27 million are in the private sector.”

The stubborn legacy of informal pre-transition norms and behaviors dominates the transition economies. Those pre-transition economies whose formal and informal institutions were relatively coherent had less of a legacy of noncompliance to confound the transition adjustment. But those economies in which the formal rules were largely observed in their breach inherited a profound legacy of noncompliance and distrust of government. They are also characterized by acceptance of a wide range of protective and predatory behaviors that impose severe adjustment costs on the transformation process. In this important sense, institutions matter, institutional change is highly path dependent, and it is less revolutionary than may appear at first blush.

Institutions do affect economic performance, but it is not always obvious which institutional rules dominate. Where formal and informal institutions are coherent and consistent, the incentives produced by the formal rules will affect economic outcomes. Under these circumstances, the rule of law typically secures property rights, reduces uncertainty, and lowers transaction costs. In regimes of discretionary authority where formal institutions conflict with informal norms, noncompliance with the formal rules becomes pervasive, and underground economic activity is consequential for economic outcomes.

Many of the behaviors that violated the formal rules of pre-transition societies have now become legitimized in the transition period. Legitimization has been accomplished by efforts to liberalize, privatize, and legalize. Incomplete liberalization--the maintenance of arbitrary gaps between buy and sell prices--produces incentives for rent-seeking, acquisitive behaviors. Incomplete privatization--the maintenance of valuable assets in the public domain with amorphous property rights--produces incentives for predation. Incomplete legalization--the maintenance of arbitrary discretion in place of the rule of law--sustains high levels of uncertainty and high transaction costs, and discourages the reallocation of resources to productive activities.

The formal rules in most of the former Soviet republics are still very far from being incentive compatible and many aspects of the old system persist unchanged. Regulatory burdens and the number of regulatory agencies have ballooned, yet the legacy of noncompliance prevails

and independent monopolists willfully exploit property rights that remain in the public domain. The tax authority is confiscatory, and organized crime extorts private taxes. The wealth still open to rent-seeking is immense. In short, the incentive structure is such that protective and predatory behaviors tend to dominate productive behaviors with the result that lost production, corruption and a growing disparity in wealth threatens the success of the fragile process of transition.

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