



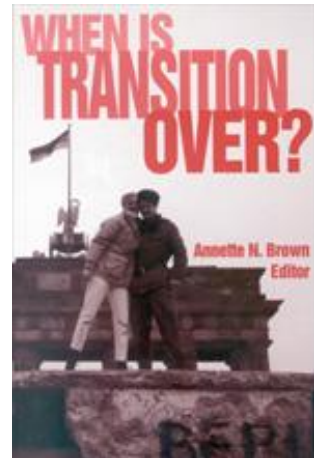
---

Upjohn Institute Press

---

# The End of Rent-Seeking

Anders Åslund  
*Carnegie Endowment for International Peace*



Chapter 3 (pp. 51-68) in:

**When is Transition Over?**

Annette N. Brown, ed.

Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 1999

DOI: 10.17848/9780585282978.ch3

Copyright ©1999. W.E. Upjohn Institute for Employment Research. All rights reserved.

# 3 The End of Rent-Seeking

## The End of Postcommunist Transformation

Anders Åslund

*Carnegie Endowment for International Peace*

During the last seven years, 27 countries in Eastern Europe and the former Soviet Union have departed from communism and attempted to build some kind of a market economy. Initially, the prescriptions presented by mainstream economists sounded rather similar in essence, although there was a great deal of debate over sequencing and speed.

Today, the most striking observation is how differently various postcommunist countries have fared. Poland returned to economic growth in 1992, and its total decline is now considered to have been less than 10 percent of gross domestic product (GDP). Other Central European countries experienced only slightly greater decreases. Most post-Soviet republics, on the contrary, have faced a drop from their prior GDP of 40–50 percent even by optimistic estimates, and several have still not returned to economic growth.

How can we explain these great differences? The theoretical economics literature on transition has focused particularly on the costs of structural adjustment and how to minimize them. The fundamental idea has been for policy to establish an optimal trade-off between various costs. However, the very large declines in GDP can hardly be considered results of any structural adjustment.

The most straightforward explanatory variable is inflation, and the degree and duration of inflation are, in turn, best explained by the degree and duration of rent-seeking. Inflation is largely caused by rent-seeking, which tends to be financed through the state budget, either through direct subsidies, such as price subsidies, or through hidden ones, such as subsidized credits issued by the central bank or exchange rate subsidies financed by foreign credits. Ultimately, these various subsidies derive from the state budget, but more transparent ones, such as direct budget subsidies, do tend to be less significant, as it is hard to defend them in any open political process.

The main drama of the postcommunist transformation in my eyes has been the strife between those who want to minimize rent-seeking and those who want to maximize it. Those who want to maximize it have benefited personally from the huge rents of the transition. Their very aim has been rent-seeking, that is, the extraction of monetary benefits from the government, either directly through subsidies or indirectly through government regulations often connected with quasi-fiscal expenditures. The opposite of rent-seeking is profit-seeking in a competitive market. In some countries, notably Russia, parts of the government have tried to contain rent-seeking, while other forces both inside and outside of government have tried to maximize rent-seeking. Increasingly, it becomes evident that rent-seeking is the key problem after communism.<sup>1</sup>

The main tasks of postcommunist transformation are all related to rent-seeking. A great deal of this behavior is caused by arbitrage between usually low, regulated state prices and higher free-market prices at home or abroad, an opportunity resulting from regulation of prices and exportation. Privatization is the most contentious issue. Many see it as the essence of rent-seeking (Goldman 1994; Nelson and Kuzes 1995), while others, including me, would rather consider it the end of rent-seeking (Kaufmann and Siegelbaum 1996).

In order to clarify the type of rent-seeking I am addressing, I shall first detail the main forms of rents in the Russian transition and assess their size and development. Curiously, rent-seeking has shrunk considerably, and the main question of this paper is to clarify how and why rent-seeking has waned. In doing so, I broaden the spectrum to the whole region, to offer an understanding of why this change has occurred in various countries.

## **THE NATURE OF POSTCOMMUNIST RENT-SEEKING**

When communism was collapsing, the Union of Soviet Socialist Republics (USSR) was a paradise for rent-seeking. Large fortunes could be made in no time thanks to connections and ruthlessness. The methods were many, but three were particularly important. Today, we can establish both the techniques and the amounts involved.

The fundamental method of rent-seeking was arbitrage: to buy cheaply anything at fixed state prices and to sell at a high free-market price. The great spree of arbitrage occurred in 1991 and 1992, when raw materials, notably oil, natural gas, and metals, sometimes cost less than 1 percent of the world market price. Traders who had access to these commodities in Russia and were able to sell them abroad made untold fortunes in a few deals. Considering domestic and world market prices and the volume of exports, total rents arising from the sales abroad of oil, gas, and metals amounted to about 30 percent of Russia's GDP in 1992.<sup>2</sup> The export rents were particularly large in Russia, because of its large sales of raw materials and semimanufactured goods such as metals, but even Ukraine had huge rents from exports of underpriced metals.

A second major source of rents was import subsidies. They arose from multiple exchange rates, allowing another kind of arbitrage. In 1992, an importer paid only 1 percent of the official exchange rate for the hard currency needed to import essential foods, and that year no less than 15 percent of Russian GDP went to import subsidies (International Monetary Fund 1993, pp. 132–183, 140). These import subsidies were financed off the budget with Western commodity credits and did not show up in the Russian budget. Yet, the Russian state is responsible for servicing and paying back these international credits. In Ukraine, gas imports have continued to be a major source of rent-seeking. Until the end of 1994, oil and gas imports were subject to privileged exchange rates. In effect, Ukraine's gas importers' privileges were financed by Russia's natural gas company Gazprom, as nonpayments to Gazprom made up the bulk of Ukraine's large debt to Russia.<sup>3</sup>

A third form of rent to the privileged was subsidized credits, which were huge throughout the ruble zone in 1992 and 1993. When prices were liberalized in January 1992, money became scarce, as the money supply did not rise as fast as prices. The state enterprises urged the government and the central bank to replenish their working capital. Unfortunately, the government and the central bank tried to accommodate this request. From June until September 1992, the Russian money supply increased by almost 30 percent a month. Worse, most of these credits were issued at highly subsidized interest rates, at 10 or 25 percent per annum, while inflation was 2,500 percent that year. Thus, the credits were virtual gifts from the state to the receiving enterprises.

The total volume of credit subsidies amounted to some 30 percent of GDP in 1992, but initially these sums were not included in the state budget.<sup>4</sup>

Even so, Russia had less credit issue than most post-Soviet states. Table 1 presents the net issue of credit in various countries in 1992. The subsidization of credits was almost as large as the net issue of credit, as very low nominal interest rates prevailed at the time. We can note that the amount of subsidized credits was larger in several other former Soviet republics than in Russia in 1992, while it was much less in the Baltic states. In 1993, Russia put its credit issue under some control and ended up with an inflation of “only” 840 percent, while the other former Soviet republics continued with very high credit issue, leading to hyperinflation in 10 of them.

Incredibly, we can conclude that gross rents from these three sources alone amounted to about 75 percent of GDP in Russia in 1992. The situation varied from country to country, but these three forms of rent were strongly developed in the whole of the former Soviet Union. None of these rents can be defended from any social point of view, but they were technically legal. Little wonder that people had a perception of lawlessness. Moreover, the division of the spoils involved a great

**Table 1 Net Revenues from Credit Issue in Post-Soviet Countries, 1992**

Country	% of GDP
Estonia	0.2
Latvia	11.9
Lithuania	19.7
Kyrgyz Republic	29.1
Moldova	32.6
Russia	32.7
Ukraine	34.5
Kazakhstan	35.7
Belarus	42.8
Turkmenistan	63.2

SOURCE: Åslund, Boone, and Johnson 1996 (p. 257).

deal of violent crime, particularly noticed in metal exports but also true in the distribution of subsidized credits.

The conventional wisdom is that the great fortunes in Russia were made through the voucher privatization, which largely benefited the managers of what were previously state enterprises. However, scrutiny of the numbers does not support this perception. By July 1997, the Russian stock market had reached a total market capitalization of about \$100 billion, after having quintupled in 15 months.<sup>5</sup> This market capitalization included most of the value in the Russian enterprise sector, notably some 17,000 enterprises subject to voucher privatization, while real estate and small and new enterprises were not included. At the time, Russia's GDP was about \$450 billion. In other words, all the fruits of the Russian voucher privatization were worth 22 percent of GDP in 1997. However, of this total figure, enterprise managers possessed only about 20 percent (Blasi, Kroumova, and Kruse 1997). That is, the enterprise managers' total gain from privatization after all of the price increases in the stock market was as little as 4.5 percent, while the total rents from the three sources discussed for the years 1991–1993 exceeded the GDP of one year.

In other countries, the direct rents from privatization were even less. Beside Russia, Poland has the largest market capitalization in what was the Soviet bloc, and it was only \$12 billion in July 1997. Most of the other former Soviet republics privatized much less and later than Russia, but, according to the World Bank, the Kyrgyz Republic had even larger income differentials than Russia in 1993, although it had barely started its privatization then (World Bank 1996, p. 68).

While the direct benefits to managers from privatization were comparatively limited, much of rent-seeking, notably the export rents, involved management embezzlement of enterprise profits, which a strong owner would put an end to. Moreover, privatization implies the depoliticization and mostly deconcentration of ownership and the division between enterprises and state. Hence, strong alliances are often broken up, particularly if independent enterprises start competing on the market, and transparency also increases. Thus, privatization is likely to contribute to the end of rent-seeking, even if the very process of privatization may involve a limited amount of rent-seeking.

The significance to personal wealth of rent-seeking versus privatization becomes even more evident if we identify the social groups that

are perceived as particularly rich in Russia. The first group consists of bankers, but most of the banks are new creations (Dmitriev et al. 1996). Clearly, the bankers' benefits were not so much from bank privatization as from subsidized credits and export rents. The second group comprises the oil and gas barons, who made their fortunes on export rents from 1991 through 1993: only in 1994 did their enterprises start being privatized. A third group is commodity traders, who thrived on both export rents and import subsidies.

In Ukraine, the metal exporters and the gas importers are the notably rich people, and in neither industry did any privatizations take place until 1997. Consistently, Ukrainians do not share the Russian view that privatization has benefited the newly rich in business. Thus, the evidence suggests that privatization does not lead to primary rent-seeking. It is another matter that those who already have money can buy assets and advance themselves further.

To conclude, a relatively small group has profited enormously from the rent-seeking that arose during the end of communism and the birth of capitalism in Russia. The foremost rents have been export rents, subsidized credits, and import subsidies. They have been strongly concentrated in the hands of some state enterprise managers and early commercial operators in trade and finance. In contrast to profits, these rents have been extracted thanks to privileged access and corruption rather than from competition on a free market. The rents have been shaped by state regulations that have effectively favored the privileged. Privatization has hardly contributed to this process.

## **WHY WAS RENT-SEEKING SO LARGE IN THE FORMER SOVIET UNION?**

The general impression is that rent-seeking has been far greater in Russia than elsewhere. However, the same conditions that apply to Russia are largely true of the other former Soviet republics, save the Baltic states. The contrast is rather between the former Soviet republics and East-Central Europe. There are many reasons why rent-seeking was worse in the former Soviet republics. The causes were both economic and political. To a considerable extent, the severity of rent-

seeking was the curse of the communists. The communists abolished private ownership in order to make the transition to socialism irreversible, but if there had been private ownership of the means of production, rent-seeking would have been much more limited.

The fundamental problem was political, namely, that the Soviet system created a small elite, about 1 percent of the population, that was virtually omnipotent. This elite controlled all levers of power and faced few restraints. In the old days, the system regulated itself, not by law, but through the Communist Party, its control organs, and the KGB. These mechanisms could not possibly be reconciled with a democratic state, the rule of law, or a market economy. Therefore, the controls had to go with the demise of communism and left the old communist elite more unrestrained than ever.

The postcommunist state was very weak. The absence of all kinds of normal institutions—political, market, economic, and legal—meant that few formal restrictions were at hand. Communism was contemptuous of the rule of law and tried to erase it. Instead, the *Nomenklatura*, the communist elite, was a law unto itself. The people with the best connections and the strongest will won regardless of the moral standards they represented. This situation fits well with Mancur Olson's logic of collective action. In an atomized society such as Russia, small groups with a lot at stake were likely to be the best organized and most effective (Olson 1971). It was obvious that wild rent-seeking would arise with the end of communism and that this rent-seeking could really be considered a "poison pill" planted by the communists, that is, a trap ensuring that the costs of abandoning communism would be great. The weakness of the postcommunist state was undoubtedly greater in the Soviet Union than in East-Central Europe, because Soviet communism lasted longer and was more ruthless.

Another problem with the postcommunist state was that democracy was weak. There is a strong correlation between political regime and economic reform strategy. Only democracies ruled by liberal governments attempted radical reforms, while all of the socialist governments, democratic or not, opted for gradual reforms initially (Åslund, Boone, and Johnson 1996, pp. 223–225). It was natural that the socialist governments chose gradual reforms, because these led to the most rent-seeking, which was in the interest of the strongest members of the old elite. That only some of the democratic regimes opted for radical



reforms can be explained partly by new leaders not understanding the problems they faced (which is also reflected in the Western debate over postcommunist transformation), and partly by corrupt interests of the leaders. As the Central Asian countries show, dictatorships do appear to indulge in more rent-seeking. Hence, the idea that enlightened dictatorship should be beneficial to postcommunist transition seems misplaced, as any postcommunist dictatorship by necessity would control huge state resources, while being subject to little or no restriction.<sup>6</sup> Conversely, the stronger democracies in Central Europe (e.g., Poland, Czech Republic, and Hungary) and the Baltic countries (Estonia, Latvia, and Lithuania) did a great deal to eliminate rent-seeking at an early stage.

An additional political factor that influences rent-seeking is the strength of civil society. Unfortunately, in the postcommunist state, civil society has largely been very weak and could therefore do little to restrain rent-seeking. The foremost exception is Poland. Its strong trade unions, workers' councils, Catholic Church, and private peasants were vehemently against radical reform, but, by checking the powers of state enterprise managers and local officials, they managed to rein in rent-seeking early so that it was barely perceived as a major problem. Workers' councils also existed in Hungary, where they had some power, while those in the former Soviet Union disappeared without any significant impact.

Wherever the media's quality and independence were sufficient, it exerted beneficial pressures on rent-seekers. Again, the Central Europe and Baltic countries came out well, but Russia also benefited from strong media of high quality and independence from government, although much of the media has now fallen into the hands of some of the new major rent-seekers. At the same time, strong criticism by the Russian media has led to the misperception in many places that the problems in Russia are worse, while the point is rather that they are better known.

Thus, the overall power of the old elite over the rest of society differed between the regions of the former Soviet bloc, and with that the rent-seeking varied. I do not possess an overall measure of the extent of rent-seeking in the transition, but the height and duration of inflation are a good proxy, as most rent-seeking was eventually financed through the state budget and thus boosted the budget deficit. By that standard,

the Commonwealth of Independent States (CIS) suffered particularly badly from rent-seeking, and Central Asia, Caucasus, and Ukraine most of all. Note that most CIS states were worse off than Russia. The Balkans followed next, as illustrated by the inflation crisis in Bulgaria and Romania as late as 1997. The Baltics have actually done better than those Balkan states, while the four Visegrad countries (Czech Republic, Hungary, Poland, and Slovakia) and Slovenia form a category of their own with relatively little suffering.

There were also strong economic grounds for the prevalence of rent-seeking. The situation was aggravated by the nature of the communist economic system, which was really a form of kleptocracy. The command economy in its ideal form did not work, and most market economic adjustments were formally illegal. Hence, the custom developed to steal whatever you could, and the limit was set by repression rather than by law. An old anecdote ran, "Which is the richest country in the world? The Soviet Union, because everybody has been trying to steal as much as they can since 1917, and there is still plenty to steal." An important reason why the collapse of communism was so peaceful was that the old elite had split into an ideological hard core and an economically oriented group that wanted to abandon communism for personal economic gains. However, the latter did not really want a competitive market economy. They preferred an intermediary stage in which they could keep control over economic assets, benefiting from a multitude of market distortions, while not suffering from the hardship of market competition. Naturally, these tendencies were worse in the Soviet Union than in East-Central Europe due to the duration and severity of communism; the same was true of more specific economic causes.

In the former Soviet Union, there were no market economic standards of any kind, and economic distortions were extraordinary. The relative prices were particularly perverse, with domestic prices sometimes less than 1 percent of world prices in 1991 at the market exchange rate. The greater the discrepancy between domestic prices and world prices, the greater the arbitrage, and the more distorted the relative prices were, the stronger the resistance against price liberalization. Interest rates had played no role in the Soviet system, and no capital or credit markets existed.

Another form of extortion was the wholesale trading system of the former Soviet Union, which to a considerable extent was based on politics rather than on economic calculation. Transportation costs were disregarded, while hauls could be enormous. Thus, many economic activities could not be justified if based on market pricing. In addition, defense expenditures probably comprised about one-quarter of GDP towards the end of the Soviet Union, while they have fallen to about 3 percent in postcommunist Russia. Thus, some 22 percent of GDP became redundant.

Another economic cause of massive rent-seeking was the deep financial crisis that all postcommunist countries but Hungary and Czechoslovakia faced at the end of communism; this crisis was particularly severe in the former Soviet Union. One of its aspects was a huge deficit of possibly up to 30 percent of GDP in 1991; another was that the Soviet Union defaulted on its foreign debt obligations in 1991, which in turn led to an extremely low free exchange rate. The budget deficit was financed with a huge monetary emission, and inflation skyrocketed as soon as prices were liberalized. The low exchange rate further intensified the problems of price liberalization, while it increased the opportunities for rents.

Finally, the larger the natural resource endowment, the greater the natural rent, and the richer the opportunities for rent-seeking, particularly in exports. This situation points to more opportunities for rents in the oil- and gas-rich countries—Russia, Kazakhstan, Azerbaijan, and Turkmenistan—which coincides with our perception of reality. It is not by chance that some of the largest fortunes in Russia appear to have been amassed in the oil and gas sectors. There are now a number of billionaires, and, at least until 1996, these were created by trade rather than by management privatization.

A combined political and economic reason for the lack of restraints on rent-seeking in the former Soviet Union was the extraordinary public ignorance of what a market economy really meant. Therefore, the rent-seekers could get away with all kinds of arguments that were unacceptable in East-Central Europe. There was no understanding whatsoever of capital and credit markets or that interest should reflect a justified price of capital. For example, Russian industrialists were up in arms when the central bank raised the official refinance rates from 50 to 80 percent in the spring of 1992, while inflation that year

amounted to 2,500 percent. Their argument ran that no Western country had such a high (nominal) interest rate, saying nothing about how no Western country had such large negative real interest rates. Similarly, post-Soviet public opinion reflected the conviction in 1992 that monetary emission and large budget deficits stimulated production. The concepts of fiscal and monetary restraints were not only unknown, but disdained. Indeed, inflation was thought of as stimulating production, and many old Soviet economists spoke of the necessity of living with hyperinflation for some time.

Marxist production fetishism remained very strong. Hence, many were against full liberalization of trade, because they argued that it would not give any increased output, not realizing that the very allocation of production is vital for the functioning of an economic system. As newly appointed prime minister, Viktor Chernomyrdin argued that Russia did not need any “bazaar.” The production fetishism also led to weird perceptions of value, for example, that smokestacks were worth fortunes while real estate and land were worth little. Even if a majority was in favor of private property, popular biases prevailed against some kinds of individual ownership, notably of large enterprises and financial institutions.

A conviction persisted that Russia was dominated by large production monopolies, which, according to the elite, justified far-reaching control of trade; on the contrary, the real problem was trade monopolies, which could only be checked through extensive liberalization of trade (Brown, Ickes, and Ryterman 1994). Similarly, it was argued that Russia lacked “market infrastructure” and therefore could not withstand a swift deregulation of trade.

The lack of economic understanding aroused an unjustified fear of massive unemployment, while the true dilemma was poverty caused by excessively hesitant economic policies that led to high inflation. Similarly, there was a very human fear that fast changes would be detrimental, while the opposite was actually true. Characteristically, virtually all of these obscurantist arguments favored gradual or no changes and thus the rent-seekers.

It does appear highly plausible that rents have been greater in Russia than elsewhere. These arguments, apart from resource endowments, apply equally well to all CIS states, so I am not focusing on a

primarily Russian situation. Only the Baltics have escaped many of the problems.

## **HOW RENT-SEEKING HAS BEEN REDUCED**

Today, these blatant forms of rent-seeking have largely ceased. The only postcommunist countries that have not put their economies in elementary order with tenable macroeconomic stability are Belarus, Turkmenistan, and Tajikistan. Rent-seeking raged from 1991 to 1993 and has subsided since. The reduction of rent-seeking tells us a great deal about what was really important in the transition from a command economy to a market economy.

Technically, it was easy to abolish rent-seeking. Only a few fundamental measures were undertaken. In order to eliminate arbitrage, it was necessary to apply three measures: to decontrol all prices, to liberalize both domestic and foreign trade, and to unify the exchange rate. Largely, all of this has been accomplished in most CIS countries, although corruption and many minor but harmful regulations remain. Dishonest officials at all levels defend regulations in order to extort bribes.

Interest subsidies were abolished in the fall of 1993 in Russia and in most CIS states in 1994. Most countries have had high positive real interest rates since then. The standing of the central banks has been strengthened; some have obtained statutory independence, and all pursue firmer monetary policies. As a result of the abolition of subsidized credits, exchange rates have stabilized. The opportunities for rent-seeking or easy money in banking have largely disappeared.

As a consequence of all of these measures, gross rents have fallen sharply. In Russia, gross rents probably dropped to about 10 percent of GDP at the end of 1995 from over 75 percent of GDP in 1992. In other CIS countries, a similar development took place, although the peak must have varied considerably. The remaining rent-seeking came primarily from other sources: state guarantees, budget subsidies, and monopoly rents, while a small amount of export rent persisted. In other countries, such as Belarus and Ukraine, import rents have continued to be prominent.

The larger and more interesting issue, however, is the political economy of reducing rent-seeking. How was it possible to cut this misappropriation so swiftly? The rent-seekers had acquired great economic and political power. In many countries, they ran the government, while they held the government hostage in others. How could the behavior be changed so significantly in just a few years in most of the countries concerned? Fortunately, there have turned out to be many ways, both political and economic, of eliminating rents.<sup>7</sup>

The best approach is undoubtedly a swift and comprehensive radical reform, as a broad economic literature has long argued (Lipton and Sachs 1990). The former Polish minister of finance made the point that the government has a period of grace, a period of extraordinary politics, when out of idealism the population accepts a great deal of change. That is when as much economic reform as possible should be implemented (Balcerowicz 1994). This timing was achieved in Poland, the Czech Republic, Estonia, and, to a reasonable extent, in Latvia and Lithuania.

Even when initial overall reforms have failed, partial reforms have still turned out to be surprisingly successful in the elements that were introduced. In general, few policy reversals have occurred. For example, there was no going back after Deputy Prime Minister Yegor Gaidar succeeded in deregulating prices in Russia in January 1992. After he and Minister of Finance Boris Fedorov abolished subsidized credits in September 1993, there were hardly any calls for new subsidized credits. Similarly, after Ukraine unified the exchange rate at the end of 1994, no opposition was heard. The success of partial reforms is somewhat surprising, considering that partial reforms usually failed under communism (Kornai 1992). Presumably, the conviction of the inevitability of a market economy was strong enough to break some resistance, and after one market economic norm had been adopted, that approach started reinforcing itself. In the public mind, the new norm became the natural standard, and, as some economic interests started benefiting from the policy, they defended it.

Over time, it becomes easier to attack rents simply because they tend to decline. There are many reasons for this. The inflation tax decreases, as people and enterprises realize that money is not a true store of value during high inflation, and they keep increasingly less, which in turn leads to a greater velocity of money. Foreign trade rents

shrink, as the initial, very low exchange rates appreciate in real terms, and extreme price distortions are simply too expensive to maintain, so that any government has to reduce them. Eventually, no government can finance a large budget deficit by any means after even the inflation tax has been reduced, and, with other expenditure cuts, rents have to be reduced. The gradual decline in rents might be an important reason why the resistance against radical economic change is so great at the beginning of a reform effort. The early opposition exists, not only because people do not understand reforms and fear the unknown, but also because the rent-seekers benefit the most then. Later on, they may let the rents go. This timing of rents largely explains why the same postcommunist regime in Moldova suddenly switched to a radical economic reform policy in 1994, after having won an election campaign by promising gradual reform.

Privatization has often been discussed as a form of rent-seeking but should instead be seen as a primary means of its termination (Kaufmann and Siegelbaum 1996). There are numerous reasons why this should be the case. First of all, privatization introduces real owners, who tend to be concerned about their enterprises (Boycko, Shleifer, and Vishny 1995). Ludwig von Mises' old dictum holds true: the very foundation for profit-seeking is often considered to be private ownership. Privatization implies depoliticization and individualization of enterprises. Moreover, as state enterprises need massive restructuring, suffer from underinvestment, and are usually badly managed, their assets comprise a finite resource that is not likely to be more than one-tenth of GDP in the early stages of the transition. Thus, in hindsight, it is difficult to understand all of the concern about the privatization of large enterprises, as so little value was actually involved. Kazakhstan turned to radical reform policies in late 1994 and stuck to them, partly because of shrinking rents and partly because of swift insider privatization.

Ultimately, rent-seeking leads to steep falls in output and in the standard of living. Therefore, rent-seekers tend to be unable to cheat the voters for long if democracy is being maintained. Elections have repeatedly ousted regimes of rent-seekers and engineered more radical economic reforms, notably in Ukraine in July 1994, in Romania in November 1996, and in Bulgaria in April 1997. Alas, if there is no democracy, this important method of correction is missing. Telling examples are Belarus, Turkmenistan, and Tajikistan.

Rent-seeking does not only reduce output but usually causes a financial crisis, which means that tax revenues shrink, and the government has to cut the budget. This crisis is normally part of the reason for sounder economic policies. It illustrates how important it is that the international community not be bankrolling countries that pursue bad economic strategies. A good current example is how Russia, or rather Gazprom, has been allowing Belarus in particular to run up large arrears.

When a financial crisis arises, most countries have nowhere to turn but to the International Monetary Fund (IMF), which ordains its standard economic policies: deregulation of prices and trade, which eliminates price subsidies; a positive real interest rate and the abolition of all interest subsidies; a unification of the exchange rate, which does away with import subsidies; a limited budget deficit; and restrained monetary expansion. All of these measures serve to abolish rent-seeking, and because the IMF provides substantial financing up front, it has great clout.

Finally, people need a broad understanding of what a market economy is and what it is not, so that they realize what rent-seeking is and how much it costs them. In the end, sizable rent-seeking can only be maintained with political repression, and even so it has to be relatively limited, as the available sources of financing run dry.

## **THE END OF TRANSITION IS THE END OF RENT-SEEKING**

In hindsight, it is evident that postcommunist transformation has largely been a question of controlling rent-seeking. The earlier that has been done, the sooner a country has returned to economic growth. Rent-seeking was enormous in the countries of the CIS but much less in East-Central Europe. There were many political and economic reasons for the extraordinary rent-seeking in the post-Soviet countries, but they essentially involved the lack of restrictions on a small elite left behind by communism. The damage caused by rent-seeking has been huge, but it has, after all, diminished sharply within a few years. A key



issue is that large rents naturally become impossible to finance in the long run; also they are not politically sustainable.

Russia's financial crisis, which culminated with both devaluation of the ruble and default on government debt obligations in August 1998, can serve as an illustration. In Russia, the rent-seekers thrived on partial reforms in 1992 (Hellman 1998), but soon rents started declining. Russia had become highly pluralist and competitive. Therefore, the competition over rents intensified, which drove down rents further (Shleifer and Vishny 1993). The financial crisis reflected a desperate competition over declining rents, extreme short-sightedness of the rent-seekers, and their total absence of social conscience. The collapse itself reduced the few remaining rents further and may very well have laid a new base for more radical and thus more socially oriented reforms in Russia, although the rents might still reappear in other forms.

#### NOTES

1. I made a first attempt to sort out rent-seeking in Russia in Åslund (1996, pp. 12–16). This paper owes a great deal to my collaboration with Peter Boone and Simon Johnson (Åslund, Boone, and Johnson 1996), to whom I express my gratitude.
2. In 1992, more than 70 percent of Russia's exports were subject to export quotas (Aven 1994, p. 84). Total Russian exports outside of the Commonwealth of Independent States (CIS) amounted to \$42.4 billion that year (Goskomstat 1994, p. 3). The average domestic price of these regulated exports was at most 10 percent of the world market price, and export tariffs actually collected amounted to about \$2.4 billion. GDP was only \$80 billion at the market-determined exchange rate in 1992 (Åslund 1995, pp. 145–152, 197). Hence, export rents were 70 percent of \$42.4 billion times 90 percent, minus \$2.4 billion, which equals \$24.3 billion. Considering that GDP was \$80 billion, export rents were almost exactly 30 percent of GDP. (Export rents were particularly high in 1992 because of the very low exchange rate, which meant that exports appeared expensive in relation to the GDP.) Much of the capital flight arose from export rents. For instance, an export delivery was heavily underinvoiced, that is, officially sold below the market price, but resold abroad at the market price, and the Russian exporters put the difference in their bank accounts abroad. The export statistics have been revised upwards to compensate for such underinvoicing.
3. After the privileged exchange rates were gone, state guarantees effectively subsidized gas importers, and when they were finally gone in 1996, gas importers simply benefited from monopoly rents. In addition, these individuals refused to pay others, while they insisted on being paid themselves.

4. Granville (1995, p. 67). This is not to say that all the rents were to the rich and powerful. Layard and Richter (1994, pp. 459–471) discuss the transfers between different sectors of the economy (enterprises and households), but the benefits of the rent-seekers cannot be identified with this approach.
5. Current information from Brunswick Brokerage, Moscow, early July 1997. The market capitalization of the 200 companies actively traded on the Moscow stock market was assessed at \$20.8 billion in April 1996 (*Russian Economic Trends* 1996, p. 32).
6. For a similar argument at a general level, see Maravall (1994, pp. 17–31) and Geddes (1994, pp. 104–118).
7. An initial discussion of this is found in Åslund, Boone, and Johnson (1996, pp. 273–288).

## References

- Åslund, Anders. 1995. *How Russia Became a Market Economy*. Washington, D.C.: Brookings.
- . 1996. “Reform vs. ‘Rent-Seeking’ in Russia’s Economic Transformation.” *Transition* 26: 12–16.
- Åslund, Anders, Peter Boone, and Simon Johnson. 1996. “How to Stabilize: Lessons from Post-Communist Countries.” *Brookings Papers on Economic Activity* 1: 217–291.
- Aven, Petr O. 1994. “Problems in Foreign Trade Regulation in the Russian Economic Reform.” In *Economic Transformation in Russia*, Anders Åslund, ed. London: Pinter, p. 84.
- Balcerowicz, Leszek. 1994. “Understanding Postcommunist Transitions.” *Journal of Democracy* 5(4): 75–89.
- Blasi, Joseph R., Maya Kroumova, and Douglas Kruse. 1997. *Kremlin Capitalism: Privatizing the Russian Economy*. Ithaca, New York: Cornell University Press.
- Boycko, Maxim, Andrei Shleifer, and Robert Vishny. 1995. *Privatizing Russia*. Cambridge, Massachusetts: MIT Press.
- Brown, Annette N., Barry Ickes, and Randi Ryterman. 1994. “The Myth of Monopoly: A New View of Industrial Structure in Russia.” World Bank Policy Research Working Paper No. 1331, World Bank, Washington, D.C., August.
- Dmitriev, M.S., M. Yu Matovnikov, L.V. Mikhailov, L.I. Sycheve, E.V. Timofeev, and A. Warner. 1996. *Rossiiskie banki nakanune finansovoi stabilizatsii*. St. Petersburg: Norma.
- Geddes, Barbara. 1994. “Challenging the Conventional Wisdom.” *Journal of Democracy* 5(4): 104–118.

- Goldman, Marshall I. 1994. *Lost Opportunity: Why Economic Reforms in Russia Have Not Worked*. New York: Norton.
- Goskomstat. 1994. *Sotsialina-ekonomicheskoe polozhenie Rossii 1993g.*, Moscow: Goskomstat.
- Granville, Brigitte. 1995. *The Success of Russian Economic Reform*. London: Royal Institute of International Affairs.
- Hellman, Joel. 1998. "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions." *World Politics* 50(January): 203–234.
- International Monetary Fund. 1993. *Economic Review: Russian Federation*. Washington, D.C.
- Kaufmann, Daniel, and Paul Siegelbaum. 1996. "Privatization and Corruption in Transition Economies." *Journal of International Affairs* 50(2): 419–458.
- Kornai, János. 1992. *The Socialist System: The Political Economy of Communism*. Princeton: Princeton University Press.
- Layard, Richard, and Andrea Richter. 1994. "Who Gains and Who Loses from Russian Credit Expansion?" *Communist Economies and Economic Transformation* 6(16): 459–471.
- Lipton, David, and Jeffrey D. Sachs. 1990. "Creating a Market in Eastern Europe: The Case of Poland." *Brookings Papers on Economic Activity* 1: 75–147.
- Maravall, Jose Maria. 1994. "The Myth of Authoritarian Advantage." *Journal of Democracy* 5(4): 17–31.
- Nelson, Lynn D., and Irina Y. Kuzes. 1995. *Radical Reform in Yeltsin's Russia: Political, Economic, and Social Dimensions*. Armonk, New York: M.E. Sharpe.
- Olson, Mancur. 1971. *The Logic of Collective Action: Public Goods and the Theory of Groups*. Second ed. Cambridge, Massachusetts: Harvard University Press.
- Russian Economic Trends*. 1996. Monthly Update, July 16. Moscow: Russian European Centre for Economic Policy. See <http://cep.lse.ac.uk/datalib/ret>.
- Shleifer, Andrei, and Robert W. Vishny. 1993. "Corruption." *Quarterly Journal of Economics* 108(3): 599–617.
- World Bank. 1996. *World Development Report 1996: From Plan to Market*. Oxford: Oxford University Press.

# When Is Transition Over?

Annette N. Brown

*Editor*

1999

W.E. Upjohn Institute for Employment Research  
Kalamazoo, Michigan

**Library of Congress Cataloging-in-Publication Data**

When is transition over? / Annette N. Brown, editor.

p. cm.

Essays based on six presentations given at the 33rd Annual Lecture-Seminar Series of the Dept. of Economics at Western Michigan University, held during the 1997-1998 academic year. The lecture series is cosponsored by the Department and the W.E. Upjohn Institute for Employment Research.

Includes bibliographical references (p. ) and index.

ISBN 0-88099-196-8 (cloth : alk. paper). — ISBN 0-88099-195-X (paper : alk. paper)

1. Post-communism—Europe, Eastern—Congresses. 2. Capitalism—Europe, Eastern—Congresses. 3. Post-communism—Economic aspects—Europe, Eastern—Congresses. 4. Mixed economy—China—Congresses. 5. China—Economic conditions—1976—Congresses. 6. China—Economic policy—1976—Congresses. 7. China—Politics and government—1976—Congresses. I. Brown, Annette N., 1966– II. Western Michigan University. Dept. of Economics. III. W.E. Upjohn Institute for Employment Research.

HC244.W475 1999

330.12'2'0947—dc21

99-24188

CIP

Copyright © 1999

W.E. Upjohn Institute for Employment Research

300 S. Westnedge Avenue

Kalamazoo, Michigan 49007-4686

The facts presented in this study and the observations and viewpoints expressed are the sole responsibility of the authors. They do not necessarily represent positions of the W.E. Upjohn Institute for Employment Research.

Cover photo: Border guard posing with tourist at the Berlin Wall.

© Corbis/Owen Franken

Cover design by J. R. Underhill.

Index prepared by Nancy Humphreys.

Printed in the United States of America.