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Escaping the Under-Reform Trap

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Most former Soviet republics have fallen into an economic and political under-reform trap. An intrusive state imposes high tax rates and drives entrepreneurs into the unofficial economy, which further aggravates the pressure on official businessmen. Tax revenues and public goods dwindle, further reducing incentives to register business activity. This economic under-reform trap has a political counterpart. Remarkably, Communist parties remain popular and opposed to establishing the rule of law precisely in those places where they were able to delay and derail reform. No electoral backlash prompts the reforms necessary to leave the under-reform trap. The best way out of the trap in countries such as Russia and Ukraine is increased economic and political competition among the elite. [JEL E65, H41, K42, P52]

Parts of East-Central Europe and most of the former Soviet Union have fallen into an economic and political under-reform trap. Managers hide their firms' activities underground in order to escape regulation and reduce the bribes they have to pay. High levels of underground activity keep tax revenues low, which means the government cannot afford to provide public goods, such as law and order, thus further lowering the incentives for entrepreneurs to enter the official economy. These economies are caught in a trap: as few pay taxes, the tax burden upon those who do becomes unbearable, inducing entrepreneurs to stay underground even though this keeps their economic efficiency low and prevents growth.

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At the same time, senior officials and powerful private individuals live well through corrupt deals and sharing rents.

This economic under-reform trap has also an important political dimension. Remarkably, there is little evidence of an electoral backlash against the people who led countries into the under-reform trap. Countries that have not had much reform tend to have little governmental change, quite strong Communist parties, and little impetus for more reform. Conversely, however, countries that manage to reform find that the political support for reform subsequently strengthens.

Until recently, these problems were perceived as temporary matters of transition, but it is now clear that many former Soviet bloc countries have become trapped in a rent-seeking equilibrium. Slow and ineffectual reform created the opportunity for corrupt bureaucrats and politicians to become entrenched and extract bribes from firms. High inflation offered huge temporary rents, and the longer it lasted the richer the rent seekers became. Slow privatization facilitated extortion by government officials. By the end of 2000 it was possible for an economy to be stabilized, widely privatized, and liberalized, yet remain trapped by corruption and a large underground economy. Most former Soviet republics appear trapped in this way.

Can a country break out once it is deeply in the trap? In this paper, the possibilities for two countries—Ukraine and Russia—are compared, and a two-part solution is offered. Economically, rents need to dwindle through competition and new entry, while political power needs to be dissipated as a consequence of competition among the elite. The policy goal should be to foster such competition. It seems more difficult for Ukraine than for Russia to escape from the trap, but even Ukraine has some reason to hope.

This paper updates findings first presented in Åslund, Boone, and Johnson (1996). The economics of the under-reform trap were studied in Johnson, Kaufmann, and Shleifer (1997). Here we explain the politics of the trap, both in terms of electoral outcomes and the pattern of competition among the elite.

I. The Economic Under-Reform Trap

Post-communist market economies fall into two main groups: those with sustained recovery following a relatively radical transformation, and those stuck without sustained growth because of gradual reform. In 1999, measured real GDP in East-Central Europe was 5 percent lower than in 1989, but in the Commonwealth of Independent States (the former Soviet Union without the Baltics), real GDP was just 56 percent of its 1989 level (ECE, 2000, p. 225).

While performance has diverged dramatically, measured GDP exaggerates the discrepancy, because the unofficial economy has expanded much more in the former Soviet Union than in east-central Europe. Table 1 shows the results of estimating the share of the unofficial economy in total GDP through 1995 using the electricity consumption-based methodology presented in Johnson, Kaufmann, and Shleifer (1997). Two divergent development paths are evident. The rather liberal East-Central European countries started with a relatively large unofficial economy, which peaked in 1992, and then declined moderately. In contrast, the unofficial

Table 1. Share of Unofficial Economy

Countries	Share of the Unofficial Economy (percent of total GDP)							Official GDP in 1994 (1989 = 100)	Total GDP in 1994 (1989 = 100)	Official GDP in 1995 (1989 = 100)	Total GDP in 1995 (1989 = 100)
	1989	1990	1991	1992	1993	1994	1995				
Eastern Europe											
Bulgaria	22.8	25.1	23.9	25.0	29.9	29.1	36.2	72.3	78.7	73.7	89.2
Czech Republic	6.0	6.7	12.9	16.9	16.9	17.6	11.3	81.0	92.4	84.3	89.3
Hungary	27.0	28.0	32.9	30.6	28.5	27.7	29.0	83.4	84.3	84.7	87.1
Poland	15.7	19.6	23.5	19.7	18.5	15.2	12.6	92.0	91.4	98.3	94.9
Romania	22.3	13.7	15.7	18.0	16.4	17.4	19.1	72.7	68.4	77.7	74.7
Slovakia	6.0	7.7	15.1	17.6	16.2	14.6	5.8	77.9	85.8	83.1	82.9
Former Soviet Union											
Azerbaijan	12.0	21.9	22.7	39.2	51.2	58.0	60.6	30.1	71.5	31.4	70.1
Belarus	12.0	15.4	16.6	13.2	11.0	18.9	19.3	62.5	67.8	56.1	61.2
Estonia	12.0	19.9	26.2	25.4	24.1	25.1	11.8	67.1	78.8	69.1	68.9
Georgia	12.0	24.9	36.0	52.3	61.0	63.5	62.6	15.6	37.6	16.0	37.6
Kazakhstan	12.0	17.0	19.7	24.9	27.2	34.1	34.3	51.0	68.2	46.5	62.3
Latvia	12.0	12.8	19.0	34.3	31.0	34.2	35.3	48.1	64.3	47.3	62.3
Lithuania	12.0	11.3	21.8	39.2	31.7	28.7	21.6	43.9	54.1	45.1	50.6
Moldova	12.0	18.1	27.1	37.3	34.0	39.7	35.7	41.7	60.9	43.0	58.8
Russia	12.0	14.7	23.5	32.8	36.7	40.3	41.6	51.3	75.5	49.1	74.0
Ukraine	12.0	16.3	25.6	33.6	38.0	45.7	48.9	44.2	71.6	39.0	67.0
Uzbekistan	12.0	11.4	7.8	11.7	10.1	9.5	6.5	85.0	82.6	84.0	79.0

Source: Johnson, Kaufmann, and Shleifer, 1997.
Note: We report here all Eastern European and former Soviet Union countries for which these data are available.

share in former Soviet countries was initially small and rose sharply until 1994 before flattening out. Strikingly, while the Polish unofficial economy share declined from 1989 to 1995 by 3 percent of GDP, its share in Russia and Ukraine surged by 30 percent and 37 percent of GDP, respectively. More recent work (through 1997) shows the same pattern has continued—the unofficial economy is typically 2–3 times larger, as a percent of GDP, in the former Soviet Union than in east-central Europe (Eilat and Zinnes, 2000).

Adjusting for the unofficial economy, the contraction in real GDP has been much lower than commonly supposed. In Russia, for example, output probably fell no more than 20 percent during transition, but qualitatively, the large unofficial economy is an essential part of the under-reform trap. A large unofficial economy means that few pay taxes, inciting governments to raise tax rates for those few while providing minimal public goods, thus inducing entrepreneurs to opt for the underground economy in a vicious circle.

Conversely, a marked difference has developed especially between Central Europe and CIS countries in terms of general government spending as a percent of both official and total GDP. In Central Europe (Poland, the Czech Republic, Slovakia, and Hungary), general government spending declined insignificantly from 51 percent of GDP in 1989 to 46 percent of GDP in 1999 (Tanzi, 1999). By contrast, general government spending in the CIS fell on average from 46 percent of official GDP in 1992 to 27 percent in 1999 (Tanzi, 1999).

The low level of tax collection is no reflection of liberalism in most CIS countries. While their level of actual tax collection varies greatly, the tax burden on those who actually pay taxes is much higher than in Central Europe (Johnson, McMillan, and Woodruff, 2000b). In fact, either high state revenues or high de facto tax rates have characterized post-communist countries.

The functioning of the tax system is a reflection of a broader qualitative difference between these two subregions. A group at the World Bank originally calculated a composite structural reform index, which mainly reflects external liberalization and price liberalization but also privatization (De Melo, Denizer, and Gelb, 1997). For an ideal market economy, this index would be 1.00. As early as 1992, central Europe had an average structural reform index of 0.83, while it stood at 0.29 in the CIS. Over time, the CIS countries have caught up, but when central Europe recorded 0.90 in 1999, the CIS countries reached an average of only 0.63 (see Table 2). Because of slow initial reforms, the CIS countries have become stuck at a lower level of liberalization and privatization.

While East-Central Europe and the former Soviet Union have converged greatly in stabilization, liberalization, and privatization, this is not true of fairer taxation, fewer regulations, and the rule of law. Countries with less distortionary tax and regulatory systems have larger official economies, collect more tax revenues, and provide more public goods.

The former Soviet Union is particularly bad at protecting entrepreneurs from extortion by government officials (Frye and Shleifer, 1997; Shleifer, 1997). The survey reported in Johnson, McMillan, and Woodruff (2000a) indicates that the effective or perceived tax rates are almost twice as high in Russia and Ukraine compared with three East-Central European countries (Poland, Slovakia, and

Table 2. Structural Reform Index, 1990–99

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Central Europe										
Poland	0.68	0.72	0.82	0.82	0.83	0.79	0.79	0.81	0.86	0.86
Czech Republic	0.16	0.79	0.86	0.90	0.88	0.82	0.82	0.82	0.90	0.90
Slovakia	0.16	0.79	0.86	0.83	0.83	0.79	0.79	0.77	0.90	0.90
Hungary	0.57	0.74	0.78	0.82	0.83	0.82	0.82	0.87	0.93	0.93
Southeast Europe										
Romania	0.22	0.36	0.45	0.58	0.67	0.65	0.64	0.66	0.76	0.82
Bulgaria	0.19	0.62	0.86	0.66	0.63	0.61	0.57	0.67	0.79	0.79
Baltics										
Estonia	0.20	0.32	0.64	0.81	0.83	0.77	0.78	0.82	0.90	0.93
Latvia	0.13	0.29	0.51	0.67	0.71	0.67	0.74	0.74	0.86	0.86
Lithuania	0.13	0.33	0.55	0.78	0.79	0.71	0.74	0.74	0.82	0.82
CIS										
Russia	0.04	0.10	0.49	0.59	0.67	0.64	0.71	0.72	0.64	0.64
Belarus	0.04	0.10	0.20	0.33	0.42	0.50	0.44	0.37	0.37	0.37
Ukraine	0.04	0.10	0.23	0.13	0.33	0.54	0.57	0.59	0.65	0.65
Moldova	0.04	0.10	0.38	0.51	0.54	0.64	0.64	0.64	0.76	0.76
Armenia	0.04	0.13	0.39	0.42	0.46	0.54	0.61	0.61	0.76	0.76
Azerbaijan	0.04	0.04	0.25	0.31	0.33	0.40	0.44	0.51	0.61	0.61
Georgia	0.04	0.22	0.32	0.35	0.33	0.50	0.61	0.66	0.79	0.79
Kazakhstan	0.04	0.14	0.35	0.35	0.42	0.50	0.64	0.66	0.79	0.72
Kyrgyzstan	0.04	0.04	0.33	0.60	0.71	0.71	0.67	0.70	0.82	0.79
Tajikistan	0.04	0.11	0.20	0.26	0.42	0.40	0.40	0.39	0.55	0.58
Turkmenistan	0.04	0.04	0.13	0.16	0.29	0.27	0.27	0.36	0.36	0.36
Uzbekistan	0.04	0.04	0.26	0.30	0.50	0.57	0.57	0.54	0.57	0.50

Sources: De Melo, Denizer, and Gelb (1997); Havrylyshyn and Wolf (1999), p. 34; authors' calculations from EBRD (1998), p. 26, and EBRD (1999), p. 24.

Notes: This index was originally established by De Melo, Denizer, and Gelb (1997), with World Bank assessments for 1990–94. They also indicated how their assessments were related to EBRD indices. Havrylyshyn and Wolf (1999) updated their series for 1995–97, while we have updated correspondingly for 1998 and 1999. The formula is straightforward. The first element is 0.3 times EBRD's indices for price liberalization and competition policy. The second element is 0.3 times EBRD's index for trade and foreign exchange liberalization. The third element is 0.4 times EBRD's indices for large-scale privatization, small-scale privatization and banking reform. Each index is normalized to reach a maximum of 1. Thus, this index represents liberalization to 73 percent, while the rest is privatization. The weights have been arbitrarily selected, but actually it does not matter much what weights are chosen for the countries relative standing to one another, as the covariance is great.

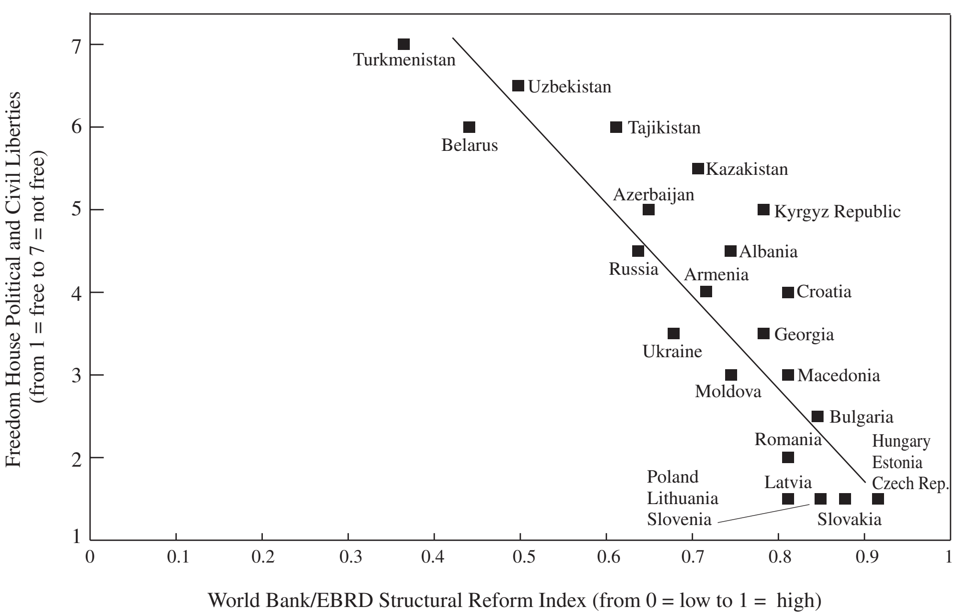
Romania). The evidence suggests that Central Europe, in particular, has made substantial progress towards reforming its institutions, while most of the former Soviet Union lags far behind, being caught in an under-reform trap, with high effective taxation and intrusive regulation.

The most powerful entrepreneurs respond with various forms of "state capture" (Hellman, Jones, and Kaufmann, 2000), effectively privatizing public goods such as taxation and regulation to their own benefit, driving out competitors who are trying to obey the law. Small entrepreneurs exit the official economy, and about half of the economy is now underground. Russia, Ukraine, and most of the CIS have become true rent-seeking societies with a suboptimal equilibrium of low economic efficiency (for modeling of such an equilibrium, see Johnson, Kaufmann, and Shleifer, 1997).

II. The Electoral Under-Reform Trap

The economic under-reform trap has a political counterpart. In a democracy, it would be reasonable to presume that informed citizens would vote for political parties advocating policies that have brought about economic growth in other countries. In general, among postcommunist countries, market reform and democracy are strongly positively related, as Figure 1 shows. Full democracies have usually undertaken advanced market reform, while semi-democratic states have usually pursued limited reform, and real dictatorships have done little reform, as is specified in Figure 2.

Figure 1. Democracy and Market Reform, 2000



The countries of particular interest to us are those that have gotten stuck in an under-reform trap—those in the middle of Figure 1: Ukraine, Moldova, Bulgaria, Romania, and Russia. These countries have underperformed in terms of economic reforms and economic growth (see Tables 1 and 2), and even so, the responsible governments have repeatedly survived relatively free elections. How could this have happened?

Figure 2. Democracy and Market Reform

	Advanced Reform	Limited Reform	Limited Market Reform
Free	Poland Czech Republic Estonia Hungary Latvia Lithuania Slovenia Slovakia Romania Bulgaria		
Partialy free	Croatia Macedonia	Albania Armenia Georgia Moldova Ukraine Kyrgyztan Russia Azerbaijan	
Not free		Kazakhstan	Belarus Tajikistan Turkmenistan Uzbekistan

Note: Countries were classified by Freedom House (2000) as "free" "partly free," or "not free." The borderline between "advanced reform" and "limited reform" has been put at 0.80 on the EBRD structural reform index for 2000, and as borderline between "limited reform" and "little market reform," the index value 0.62 has been chosen (EBRD, 2000).

Assessing Election Results

In order to understand the politics of under-reform, we scrutinize election results. We review only parliamentary election outcomes because presidential elections tend to be dominated by personal factors and offer a narrow choice, while local elections are rarely relevant for national policy. Only election results in countries with a reasonable degree of political freedom can be considered. Nineteen countries in the postcommunist region fulfill this criterion, being classified as either free or partly free by Freedom House (Karatnycky, Motyl, and Graybow, 1999, p. 15). Seven countries do not qualify as even partly free, and they are therefore excluded (Azerbaijan, Belarus, Kazakhstan, Tajikistan, Turkmenistan, Uzbekistan, and Yugoslavia). To categorize the electoral outcomes, we need some kind of party structure. Hence, Kyrgyzstan is omitted, because it had its first multiparty elections in 2000, and even then parties played only a minor role.

Party structures vary much more in postcommunist countries than in Western Europe. For our purpose, electoral outcomes are most easily classified by the Communist party and its direct successors. Although the Communist parties have been renamed in most countries, one evident successor party usually exists, and splinter groups tend to alter their appearance.

Figure 3. Communist Party Electoral Performance and Market Economic Transformation, End-1999

	Communist Parties Doing Well	Communist Parties Doing Badly
Radical transformation	Hungary Poland	Croatia Czech Republic Estonia Latvia Lithuania Slovakia Slovenia
Incomplete transformation	Bulgaria Macedonia Moldova Romania Russia Ukraine	Armenia Georgia

Note: The borderline between "radical transformation" and "incomplete transformation" has been put at 0.80 on the strtuctural reform index for 1998 (see Table 2), and as borderline between "communist parties doing well" and "communist parties doing badly" 20 percent of the votes in the last elections up to summer 2000 has been chosen (see Table 3)

Even Communist parties evolve. They can be divided roughly into two groups: those turning Social Democratic and those remaining Communist parties (sometimes becoming nationalist). Among the democratic countries, the old Communist parties have become Social Democratic in Poland, Hungary, Slovakia, Lithuania, Slovenia, and Macedonia, while they remain hard line in the Czech Republic and throughout the former Soviet Union. This dichotomy remained largely true at the end of 2000.

Parliamentary Election Results

All the democratic or semidemocratic countries in the region have undertaken some market economic reforms. If such reforms were truly unpopular, we would expect Communist parties to gain popularity and even win electoral majorities. However, Table 3 shows that Communist parties have fared poorly regardless of country and policy, with the exception of the marginal cases of Albania (where the "democratic" forces abandoned democracy in 1997) and Mongolia in 2000 (which is disregarded here as a very special case). By 1997, no other Communist party in the region had attained one-third of the votes cast in the most recent democratic election, and the Communist party was not the senior partner in any government. The Communist parties in Italy, France, and Finland were actually larger during the Cold War. Apparently, the popular nostalgia for communism has been very limited.

Results from all the parliamentary elections are summarized in Table 3, and these offer some intriguing conclusions. At the end of 1999, these countries could

Table 3. Ex-communist Vote Share in Parliamentary Elections in Post-communist Countries *(Percent)*

Country	First Election	Vote Share	Second Election	Vote Share	Third Election	Vote Share	Fourth Election	Vote Share
Albania	March–April 1991	56.2	March 1992	25.6	May 1996	Rigged (20.4)	June–July 1997	52.8
Armenia	1990	minority	July 1995	12.1	May 1999	12.0		
Bulgaria	June 1990	47.2	Oct. 1991	33.1	Dec. 1994	43.5	April 1997	22.1
Croatia	April–May 1990	26.5	Aug. 1992	5.4	Oct. 1995	Tiny	Jan. 2000	n.a. [7]
Czech Republic	June 1990[1]	13.6	June 1992	14.2	May 1996	10.3	June 1998	11.0
Estonia	March 1990[2]	Minority	Sept. 1992	13.6 [3]	March 1995	5.9	March 1999	6.1
Georgia	Oct.–Nov. 1990 [2]	Tiny minority	Oct. 1992	2.7 [4]	Nov. 1995	3.8	Oct. 1999	Tiny
Hungary	March–April 1990	10.9	May 1994	33.0	May 1998	32.9		
Latvia	March–April 1990 [2]	minority	June 1993	12.0 [5]	Sept.–Oct. 1995	12.9 [5]	Oct. 1998	14.7 [5]
Lithuania	Feb.–March 1990 [2]	minority	Oct.–Nov. 1992	42.6	Oct.–Nov. 1996	9.5	Oct. 2000	31.1
Macedonia	Nov.–Dec. 1990	25.8	Oct. 1994	48.3 [4]	Oct. 1998	25.2		
Moldova	Feb. 1990 [2]	majority	Feb. 1994	22.0	March 1998	30.1		
Mongolia	July–Aug. 1990	61.7	June 1992	57.0	June 1996	40.5	July 2000	Majority
Poland	June 1989 [6]	minority	Oct. 1991	12.0	Sept. 1993	20.4	Sept. 1997	27.1
Romania	May 1990	66.3	Sept. 1992	37.9	Nov. 1996	21.5	Nov. 2000	37.0
Russia	March 1990 [2]	majority	Dec. 1993	12.4	Dec. 1995	22.7	Dec. 1999	24.3
Slovakia	June 1990[1]	13.6	June 1992	15.2	Sept.–Oct. 1994	13.1	Sept. 1998	14.7
Slovenia	April 1990	22.7	Dec. 1992	13.6	Nov. 1996	16.1	Oct. 2000	15.8
Ukraine	March 1990 [2]	majority	March 1994	minority	March 1998	24.7		

Sources: Inter-Parliamentary Union (www.ipu.org). Chronicle of Parliamentary Elections and Developments. 23–29 (1988–95); Commission on Security and Cooperation in Europe. Elections in Central and Eastern Europe. December 1990; Facts on File World News Digest.

Note: Countries that were classified by Freedom House (Karatnycky, Motyl, and Grabow, 1999) as not free have been excluded. They were Azerbaijan, Belarus, Kazakhstan, Tajikistan, Turkmenistan, Uzbekistan, and Yugoslavia. Kyrgyzstan has not had any party elections.

[1]The June1990 election result for the Czech Republic was for all of Czechoslovakia.

[2]Political parties were not allowed during the 1990 elections in any of the countries of the former Soviet Union or in the 1994 elections in Ukraine.

[3]In September 1992 in Estonia, the parties Safe Home, Our Home Estonia, and the United People's party qualify as Communist parties, although they were primarily Russian national parties.

[4]For the October 1992 result in Georgia, and Macedonia in October 1994, the number shown is share of seats, not votes.

[5]Latvia has had a series of Russian nationalist parties (Harmony for Latvia, Rebirth of the Economic Union, and the National Harmony Party), but they have been true Communist parties, led by the old hard-line communist leaders.

[6]The June 1989 election in Poland was only partly free.

[7]In January 2000, the Croatian former communists were included in a broad victorious coalition party.

be divided into countries where the Communist parties received more than 20 percent of the votes cast in the latest parliamentary election (nine countries), and countries where they obtained less than 20 percent (eight countries). The threshold is a natural division with no country in the interval of 16–21 percent. The summary classification is displayed in Figure 3, matching this political division by their degree of market reform in 1998 (with the threshold set at 0.8), splitting the democratic transition countries into four quadrangles.

Three typical electoral paths can be distinguished. First, the top left box in Figure 3 contains two countries that have undertaken radical marketization, and even so, their Communist parties are doing well, namely Poland and Hungary. Their communists were almost routed in 1991 and 1990, respectively. They have staged strong comebacks to about 30 percent of the vote, however, as they were thoroughly reformed early on, becoming right-wing Social Democratic parties. These countries' successful market economic transformation convinced even communist leaders to reform, securing their political survival, and their conversion led to the formation of a market economic consensus.

Second, in nine countries the Communist parties are now weak, receiving only 10–16 percent in the latest elections. These countries have all gone through substantial market economic transformation and achieved substantial and lasting growth. They should all be in the right upper box in Figure 3 (the latecomers, Armenia and Georgia, have almost qualified). All these Communist parties have undergone far-reaching reform, with the exception of the Latvian National Harmony party, but not fast enough to jump onto the market economic bandwagon. A broad consensus in favor of market reform was achieved without them. This does not mean, however, that they are discredited for good. In Lithuania, the former communists made a strong comeback in the elections of 2000 as social democrats.

The bottom left box in Figure 3 represents the political under-reform trap. It contains six countries where Communist parties have been relatively successful, while the market economic transformation has been insufficient. These six countries are Bulgaria, Romania, Macedonia, Moldova, Ukraine, and Russia. Two different patterns are in evidence, depending on whether the Communist parties stayed in power or not.

In Bulgaria and Romania the former Communist parties held on to power in democratic elections until 1996–97. The cause of their demise was rampant economic crises, for which the communist governments were clearly responsible. In these two countries, the corrupt policies of partial reform were discredited, and people voted against their bitter experiences of communist governments in the post-communist period. In Bulgaria, a break with the system of rent seeking occurred, while the communists returned to power in Romania in 2000, illustrating the tenacity of the under-reform trap.

In Russia, Moldova, and Ukraine, the old Communist parties have remained strong, usually gathering 20–30 percent of the votes cast. While not formally in power in Ukraine or Russia,[1] the communists have been highly influential in

[1]Moldovan governments have been both unstable and hard to categorize precisely.

parliament, as the electoral system made them over-represented, allowing them to block reform legislation in coalition with other parties.

Whether in government or not, strong Communist parties have ensured that the state has remained all-intrusive, with high taxation and extraordinary rent seeking. The natural political outcome has been a state dominated by powerful oligarchic business groups. The concentrated economic power around the state also circumscribed democracy, while politics became polarized between oligarchs and communists. Ironically, both groups favor similar economic policies and agree on having a rent-seeking state. Accordingly, the EBRD (1999) finds that state capture is the greatest in these semi-reformed countries (see also Hellman, Jones, and Kaufmann, 2000).

The communists remain strong electorally because of dissatisfaction with the new semi-reformed system, which produces little growth but great inequality, while noncommunists vote for the strongest organized contenders against the communist threat. With few independent entrepreneurs, the liberal right is too weak to counterbalance both communists and oligarchs. Thus communists remain reasonably strong and unreformed when market-oriented economic transformation is slow. This is the political under-reform trap.

III. Stickiness of the Reform Trap

The countries of greatest interest for our analysis are Russia and Ukraine.[2] Both countries failed to attain significant economic growth until 2000 because of late and partial reforms. To understand their problem, we first examine the initial rents in these societies. Next, we check the ensuing effects on the dominant economic-political groups. Finally, we consider the stability of the situation and how it may change.

Early Rents in Russia and Ukraine

A mixture of state enterprise managers, new entrepreneurs, government officials, commodity traders, bankers, and outright criminals have grown rich on government subsidies and regulations, that is, rent seeking. Today's rent seeking can be traced back to four dominant early forms of rent seeking in both Russia and Ukraine.

The first form of rent seeking was to buy commodities on the domestic market, which were cheap because of price regulation, and sell them abroad at the world market price. This required access to the commodities and export permits. About 40 percent of Ukraine's exports in 1992 were commodities (mainly metals; IMF, 1993b, p. 113), and their average domestic price was about 10 percent of the world market price. Hence, the total export rents amounted to some $4.1 billion or 20 percent of GDP in 1992. The beneficiaries were managers of state metallurgical companies, commodity traders, foreign trade officials, and some politicians. In

[2]This section draws on Åslund (1999 and 2000).

Russia, which had more commodities to export (mainly oil and metals), the export rents in 1992 amounted to $24 billion or 30 percent of GDP (IMF, 1993a).

The second method was to import certain commodities, notably food in Russia and energy in Ukraine, at a low subsidized exchange rate and resell them at a higher domestic price. The main beneficiaries were a small number of gas importers in Ukraine and food importers in Russia. In Russia, the import subsidies amounted to 17.5 percent of GDP in 1992 (IMF, 1993a), and they were probably as sizable in Ukraine, largely pertaining to energy imports from Russia.

The third form of rent seeking was access to subsidized credits. In 1993, Ukraine experienced 10,155 percent inflation, but huge state credits were issued at an interest of 20 percent a year—that is, state credits were sheer gifts, and they were given to a privileged few. In 1992, net credit expansion to enterprises was no less than 65 percent of GDP and 47 percent of GDP in 1993 (calculated from IMF, 1993b, p. 109; IMF, 1995, pp. 73, 105). In Russia, the net credit issue of the central bank was 31.6 percent of GDP, and it was less in 1993 (IMF, 1993a). Thus, these rents were greater and more lasting in Ukraine than in Russia.

The fourth form of rents was direct budget subsidies, which amounted to 8.1 percent of GDP in 1992 and 10.8 percent of GDP in 1993 in Ukraine (IMF, 1995, p. 94). In Russia, they were 10.8 percent of GDP in 1992 and 9.4 percent of GDP in 1993. In both countries, these subsidies were concentrated on agriculture and energy—that is, gas in Ukraine and the coal industry in both countries. The subsidized industries became totally criminalized by a struggle over these subsidies. In total, rents as a share of GDP were huge in both countries but somewhat higher in Ukraine than in Russia in both 1992 and 1993 because of greater credit emission in Ukraine (Åslund, 1999, 2000). Much of these rents have been accumulated abroad in tax havens.

In this way, a small select group of privileged insiders usurped a huge share of GDP in the early years of transition and grew strong. They have no reason to abandon their enormous power and wealth, which are based not on property, but on diverted financial flows. For society, the result has been sharply rising income differentials. Ukraine has reached a Gini coefficient of 47 and Russia 48, which is about the same as the Latin American average (Milanovic, 1998, p. 41). By 1996, macroeconomic stabilization was happily taking hold at long last in both countries, as the original rents dwindled, but the rent seekers stayed rich and powerful, inventing new rents.

Both Russia and Ukraine have well-developed oligarchic power structures of so-called financial-industrial groups, whose essence is to use political influence to extract rents. A good relationship with the presidency has been essential to success. In both cases, control over the media has been helpful to developing a power base.

In Ukraine, the oligarchs sit in parliament themselves and lead large parties, while Russian oligarchs tend to hire parliamentarians and purchase specific votes. The Russian oligarchs started as small traders. Then they became bankers and commodity traders, moving on to the production of raw materials for export in the mid-1990s, and now they are going into manufacturing. The Ukrainian oligarchs remain commodity traders, but a few have taken to metallurgy and the production of energy (Brady, 1999; Åslund, 2000). The government and the leading businessmen live in a curious symbiosis and mutual dependence. In order to be reelected, politicians need the support of the top businessmen (particularly those who control the media), but the tycoons can be ousted by politicians if they turn against the political leaders.

Especially in Ukraine, an iron triangle of government, businessmen, and parliament ruled the country until 1998. All three groups favored a maximum of regulation and state interference to maximize rent seeking and corruption, while the effects on the population as a whole were of little consequence. The government malfunctioned in the interests of the rent-seeking elite. This model of self-reinforcing rent seeking looked like a frightfully stable suboptimal equilibrium, reminiscent of the distribution of power in a stagnant African country (Collier and Gunning, 1999).

Yet, the nature of the oligarchs' interaction with one another and the government changes swiftly. The main institutional change occurred with privatization. Previously, the budding oligarchs merely colluded with state enterprise managers and government officials. Now, they became owners of large enterprises, which were by necessity visible. Their dependence on the state diminished. They started defending private property rights, and they represented different industrial interests. Their greater security and more clearly defined interests intensified their competition. As a result, their competition was transformed from obscure court intrigue to public politics. In Russia, this occurred in 1994, after the initial voucher privatization, while in Ukraine it happened only in 1998–99, after the large metallurgical companies had been privatized in obscure inside privatizations.

In parallel, the legal situation changed. At the end of communism, large-scale business was pervasively criminal and the murder rate rose steeply. Government was unable to provide the legal institutions that make contracts enforceable. Crime grew increasingly organized, and major businessmen established their own security organizations. Greater order reduced the murder rate (Åslund, 1997). In Russia, the internecine murdering among major businessmen ceased in 1994, while it continued until 1996 in Ukraine. In recent years, the police have reestablished their monopoly of violence, but their services are often bought by businessmen (Hellman, Jones, and Kaufman, 2000). The demand for court services is rising steeply, prompting higher bribes for judges, while civil servants are deprived of bribes, since they no longer have much to sell. After most property has been distributed by state officials, the focus of bribery moves to judges responsible for the security or redistribution of property.

Policies for Breaking the Trap

Looking back on the past decade, the fast qualitative changes are striking, and the stability of the suboptimal equilibrium must not be exaggerated. For instance, overindustrialization is soon to become a memory, as value detraction has faded. From 1989 to 1998, the share of industry in GDP in Russia and Ukraine contracted by 15 and 14 percent, respectively (World Bank, 2000). Future economic reform in the former Soviet Union should be seen in this new light. The best option of swift, comprehensive, and radical reform is no longer available, leaving two contrary alternatives, either collusion or competition.

The advantages of collusion or deal making have been analyzed by some economists and political scientists. Andrei Shleifer and Daniel Treisman (1998 and 2000) and Treisman (1998) have argued that it facilitated privatization and macroeconomic stabilization in Russia. This was certainly true for privatization. Ukraine, however, has abounded with deal making with no benefit for reform.

A competitive approach appears, instead, more likely to reduce rent seeking. In their book, *Mercantilism as a Rent-Seeking Society,* Robert B. Ekelund and Robert D. Tollison argued that mercantilism ended in Britain because of a competition between the royal court and the parliament over monopoly rents and jurisdiction. In a similar vein, Andrei Shleifer and Robert Vishny (1993) have suggested that corruption should be fought through competition rather than prohibition, which often implies a reinforcement of the monopoly of corruption, characteristic of the Stalinist system. Shleifer and Vishny (1998) and Shleifer and Treisman (2000) have devised methods for how to organize competition among rent seekers to drive bribes and rents down toward zero. When rents dwindle, smart operators might find productive business more lucrative.

Competition is the opposite of a political and economic monopoly, and it involves both politics and economics. A competitive approach to reform can be described as seven related goals: (1) to split the political and business elite into different groups; (2) to form independent political associations and enterprises with secure legal bases; (3) to encourage competition among different groups; (4) to achieve political and economic discontinuity; (5) to diminish the state's stranglehold on economy and society; (6) to achieve a maximum of transparency; and (7) to break up or regulate monopolies. This competition should aim to diminish rent seeking, thus enhancing economic efficiency.

There is a fundamental difference between taxation and regulation with regard to desirable reforms. In taxation, competition must be avoided, as it leads to the kind of overgrazing that has proliferated in the CIS and in many developing countries (Shleifer and Treisman, 2000; Johnson, Kaufmann, and Zoido-Lobaton, 1998). In regulation, however, competition can minimize bribery.

A first goal is to create more independent bodies. Throughout the post-Soviet region, rent seeking has prospered around so-called natural monopolies in energy and transportation (oil, gas, coal, pipelines, railways, and telecommunications), but many of these are not natural monopolies. Telecommunications have been divided and successfully turned competitive in Russia. Similarly, Russia has broken up its oil industry into a dozen major oil companies. Although only one of these privatizations was undertaken through competitive bidding, the Russian oil industry has been transformed into a highly competitive industry. The natural gas monopoly Gazprom, on the contrary, retains most ministerial regulatory functions, forming the main bastion of asset stripping by managers through barter and transit pricing, while it is badly mismanaged.

Coase's Theorem (Coase, 1988), that the initial distribution of property does not matter because property can be traded, has been much maligned. It presupposes the absence of transaction costs, which are very high in the transition economies. Considering high transaction costs, however, it can be modified into a less stringent hypothesis: it is more important that privatization be undertaken than how it is undertaken. Historically, states have lived without private property for centuries, while robber barons tend to be disciplined by the market within a few decades. Over time, more property legislation is promulgated, and property rights are reinforced through practice, as reflected by increased usage of courts by enterprises (Hendley and others, 1997).

According to the EBRD (1997), the private sector had grown to account for 70 percent of Russia's GDP by 1997, while the Ukrainian private sector only delivered 50 percent of GDP in that year but slowly expanded to 60 percent by 1999 (EBRD, 2000). The combination of a growing private sector and the enhancement of property rights amount to a threat to the old habits of rent seeking.

Certain state bodies also need autonomy, especially regional and local organs, from the central state. Today, they have little independence and thus responsibility, while the center is unable to supervise them, which inspires cheating by local organs and arbitrary rule by the center. Most taxes are shared between two or three administrative levels in a shifting and arbitrary fashion, which leads to additional tax revenues of regional organs being confiscated by the central state (Kravchuk, 1999). Ideally, each tax would be fully allocated to one administrative level, for instance, VAT, excise taxes, and foreign trade taxes to the central state, and property taxes to local authorities. To make the division crystal clear, each tax base should be allocated to one administration level, and each kind of expenditure should be entirely financed by one level, for instance, defense by the central government, but schools by local organs. Finally, the state tax service should be divided between the three administrative levels as well to clarify responsibility and accountability (Shleifer and Treisman, 2000). Fiscal autonomy would encourage competition between different administrative levels.

A large number of private enterprises are needed to support political competition. Autonomy for small entrepreneurs has empirically proven rather easy to create. Essentially, only two things are needed—a simplified registration system and a simple lump sum tax. The early introduction of wide-scale lump sum taxes spearheaded the evolution of many small private enterprises in Poland, which later formed the social, political, and economic base of radical market economic transition (Åslund, 1985). In 1998, Ukraine successfully launched a fixed lump-sum tax for small entrepreneurs. It has stimulated the development of millions of small enterprises, which will be the base of a true market economy.

If the state is characterized by rent seeking, state resources are used for private enrichment and the repression of enterprise. Then, falling state revenues are desirable to limit rents. With falling state revenues, resistance against a rational tax reform is also likely to fade, as leading rent seekers will no longer perceive a cumbersome tax system as an effective deterrent against business by outsiders. Or they might be too weak to block a liberal tax reform. Thus, Georgia, Kazakhstan, and Kyrgyzstan undertook radical tax reforms after state revenues had fallen sharply.

It is not enough, however, that state activities are cut for a lack of funds. Public mandates must not be left unfunded but rather eliminated. A major cause of corruption is that semiautonomous state organs try to raise their own revenues to finance state programs that remain on the books but are no longer funded by the central government (Rose-Ackerman, 1999). Such public fund-raising is usually undertaken through extortionary fees and penalties, being the most ineffective taxes and amounting to a major cause of corruption.

The most plausible interpretation of growing barter and arrears up to 1998 was that they formed a mechanism of extracting government subsidies and then privatizing these subsidies through management theft. Total enterprise subsidies amounted to no less than 16 percent of GDP in 1998 (Pinto, Drebentsov, and Morozov, 1999). Otherwise, the cost of a barter deal should be deterring at about 25 percent of the deal (Djankov, 1999, p. 131). This extraction of implicit subsidies through barter is facilitated through its nontransparency. With the financial crash in Russia, barter fell like a stone from 54 percent of all interindustry transactions to 21 percent in August 2000 (Russian Economic Barometer, 2000). A parallel development has occurred in Ukraine. The government was forced to harden its own budget constraints, demanding tax payments in cash, which eliminated the possibilities to extract tax rebates through barter or offsets. The effect of the dwindling barter has been not only greater monetization but also a leveling of the playing field, intensified competition, and economic growth.

One of the most erroneous ideas in much of the transition literature is that political and economic continuity are vital, because a valuable administrative capital exists that must be utilized (Stiglitz, 1999). On the contrary, a maximum of discontinuity is desirable in both the political and economic spheres.

The EBRD (1999) *Transition Report 1999* shows that the greater the discontinuity in the ruling elite, the more radical and successful the market economic reform. Progress in liberalization "was twice as high in countries where the political executive was replaced as in those where the incumbent from the communist era remained in office" (p. 106). Transition countries with more competitive political systems and more unstable governments have tended to achieve greater progress in economic reform. The five transition countries with the most frequent changes in government have been the three Baltic States, Poland, and Bulgaria, of which four have been among the most successful reformers (p. 112). The apparent explanation is that turnover of personnel leads to greater transparency and more checks on corruption. The greater turnover of governments can also be seen as a reflection of more effective democracy, one of the best checks on a rent-seeking elite (see Figure 1).

The same is true of certain economic discontinuity. Drazen and Grilli (1993) have modeled how economic crises may facilitate reform by undermining harmful vested interests both financially and politically. The Russian financial crash undermined the ruling oligarchy, thus facilitating substantial reforms, notably budget and tax reforms, which contributed to unexpected economic growth in 1999 and 2000. Thanks to its hyperinflation of 1996–97, Bulgaria changed political leadership through democratic elections and undertook far-reaching liberal economic reforms, seemingly breaking out of its under-reform trap. The Romanian crisis of 1996–97, on the contrary, does not appear to have been sufficiently severe. Insufficient reforms proved ineffective and allowed the comeback of rather unreformed communists through democratic elections in 2000.

Economically, market reform in Russia and Ukraine has proceeded. Both countries are now liberal and open economies with large exports in relation to their GDP (see Table 2). Some monopolies are truly natural, but they can be structured to reduce rent seeking. For example, the power companies in Russia are aligned with individual regions, and regional governors have substantial control over tariff setting and personnel appointments. Therefore, these companies have become the fiefdoms of regional leaders, who typically keep tariffs low, prohibit electricity companies to cut off local enterprises, and force them to supply regional governments for free. If several regional companies are merged, they fall outside of the control of each governor.

A popular idea in attempts to reduce corruption through administrative harassment has been the attempted establishment of one-stop shops for licensing and foreign investors in various countries, but such efforts run counter to the competitive approach and they have failed in many countries, as this implies a monopoly of corruption. Instead, several agencies could be allowed to issue the same licenses and permits, prompting them to provide better and cheaper services in competition with one another. For example, a visit to Bishkek in 1998 revealed that the city architect had swiftly registered all land for housing and issued titles for the land, because two competing agencies were doing the same, and it was enough to get title from one of them. Similarly, enterprises could be allowed to register with different agencies, as long as multiple registrations are not required. Organs at federal, regional, and local level could all be allowed to issue all licenses that exist.

The basis of civil society is public learning, which is probably a reason for the brevity of each method of rent seeking. As people have understood, reforms have become necessary. Either followers have jumped into the game to make money for themselves, for instance, driving rents down through arbitrage, or others have reacted against the rent seeking and demanded structural changes. For instance, cheap credits could be publicly defended in 1992 in Russia and Ukraine, but everybody knew they caused hyperinflation by 1994. The quality, and thus freedom, of the media is crucial for this public learning. Besides, much of the old rent seeking has been built on structural inertia and fear of change, but as the necessary structural changes proceed through downsizing by default, many obstacles to reform fade away.

Our line of argument fits the model of Daron Acemoglu and James Robinson (2000) of political losers as barriers to economic development. They argue that socially beneficial economic reforms are being blocked, "when the political power of the incumbent is threatened by economic innovation" (p. 128). Their model indicates that the incumbent monopolist is more likely to block the introduction of new technologies when political rents from staying in power are greater, when monopoly profits from blocking are greater, and when the tax revenue they can collect from rivals are smaller. While this paper discusses an oligarchy rather than a monopoly, it shows how this confluence of political and economic oligarchy works in practice.

A corollary of this reasoning is that an oligarchy is much better than monopoly and dictatorship. Belarus and Turkmenistan present a far more stable under-reform trap, which is held together by an iron triangle of 80 percent state ownership, minimal liberalization of the economy and full dictatorship (EBRD, 2000).

IV. Conclusions

Russia and most former Soviet republics have actually become rather normal market economies, because most market economies have weak rule of law, a few dominant business groups, and a close relationship between government and business. Russian and Ukrainian levels of corruption and political conflict are not unique. They have fallen into a fairly common trap: high corruption drives the economy underground and offers few incentives to enter the official economy. We have discussed this as an under-reform trap, but this is really a special case of a more general development trap.[3]

There are three possibilities for market economies trapped with weak institutions. First, there may never be growth, as has been the experience in much of Africa for decades. Second, if it is in the interest of some part of the elite, some growth may occur, and this creates the incentive for managers and governments to behave better and steal less. Growth becomes self-fulfilling and self-supporting, as in poorer parts of Europe over the past 40 years. Eventually, institutional reform occurs, but it usually requires the involvement of a third party (like the European Union). Third, rapid growth may alternate with episodes of economic collapse. This has been the experience of Latin America over the past 40 years, and it may now be the case of East Asia.

Institutions cannot be built without political demands for institutions, and such demands depend as much on the nature of the economic system as on the political system. For a dictatorship or business hegemony, any institution is harmful, as it implies a reduction of absolute power. An oligarchy may find an equilibrium, but it is potentially unstable, as is an oligopoly. The question whether there is a sufficiently strong demand for sound market economic institutions in Russia and Ukraine is a question whether the economic and political pluralism is strong enough to allow these countries to break out of their under-reform trap. The financial crash in Russia broke many oligarchs both financially and politically, while broadening the number of big businessmen. It also increased the demand for stable financial institutions in all groups of society. Meanwhile, increasing competition is bound to reduce rents, and eventually rent seekers may opt for profits instead. The driving force of positive change has to be entrepreneurs who feel they are at a disadvantage because of the privileges of others.

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[3]For evidence on the importance of institutions in economic development more generally, and the long-lasting effects of early institutions (such as how a country was colonized), see Acemoglu, Johnson, and Robinson (2000). For the size and determinants of the underground economy around the world, see Friedman and others (2000).

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