



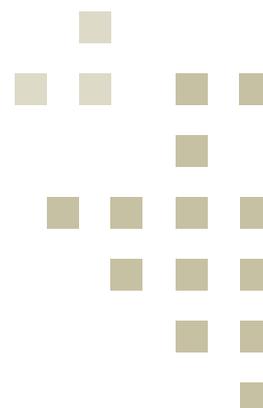
[648] Paper

A Polanyi Perspective on Post-Communist Corruption

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A Polanyi Perspective on Post-Communist Corruption

Jens Chr. Andvig

[Abstract] The paper seeks to explain the present high levels of corruption in the post-communist countries, i.e. the centrally planned economies where the communist party lost power as the outcome of a specific historical process where both the character of the former economic system as well as that policy shock itself played key roles. Among the possible explanatory factors the study focuses on the effects of production decline and the 'monetarisation' of the economy which started before the policy shock.

Introduction⁰

The question I will deal with here is the following: How to explain the extensive corruption experienced in most countries that once were centrally planned economies (CPEs) and where the communist parties¹ lost power? One approach is based on cross-section econometrics and compare the corruption in these countries with corruption in other countries looking for a common set of factors that may explain the present variation, such as GDP-levels, religion, whether the country in question was ruled by British or not, and so on.² At present I am critical to this approach, feeling that it relies on premature generalisation. It is premature when we have no good, general theory to explain its variation. Excessive generalisation may also lead us to reject genuine, but more historically specific explanations.

Let us look at our case. Countries where the communist parties broke down also experienced strong production declines. The empirical correlation between the size of the production decline and the country indicators of corruption is striking. Is it a theoretically valid connection? The market expansion in China and Vietnam also appears to go together with increasing corruption rates, but then with high growth rates. How may a production decline then become part of an explanation of higher corruption rates? As noted in Andvig (1991), corruption occurs in situations so different that one may not in general expect a given variable to have the same effects. Aggregate corruption is a rather different construct than, let us say, than private consumption where we may reasonably assume that each consumer faces a similar situation influenced by the same factors, such as their own disposable income. Thus, it is not surprising that growth rates of production (positive or negative) during market transitions may have different impact on aggregate corruption depending on whether the Communist Party has kept control or not. Hence, I will stick with production decline as part of the explana-

⁰ I thank Professors Janos Kornai and Susan Rose-Ackerman for helpful and constructive criticism. I have received useful comments by the participants at the first Trust and honesty workshop, Budapest and the 'Elster seminar' in Oslo. My colleague Per Bottolf Maurseth has contributed with many useful comment. Eilert Struksnes has corrected some of the worst English mistakes. The Norwegian Institute of International Affairs has sponsored the research.

¹ In the title I use the term *post-communism*. I use this term to describe countries where the Communist Party once was the key economic power, which it now has lost. Hence, while China and Russia both are post-socialist countries, only Russia is post-communist. It is also post-socialist.

² A typical work of this kind that focuses on the post-communist countries is Treisman (2002).

tion of the variation of corruption levels inside the group of post-communist countries. Unlike artificial counterfactual experiments explaining high corruption levels such as ‘not being ruled by the British’, declining production levels and its variation was something *experienced* by the agents who chose to engage in corrupt transaction in the post-communist countries.

In addition to production decline I will focus on what we may call the ‘monetisation’ process of the socialist economies. Unlike production declines, that was a process which has taken place in all post-socialist countries. An essential characteristic of the former socialist countries was that prices and markets played minor roles both as means of coordinating economic decisions and as incentives motivating economic agents. While not so centrally *planned* as they were supposed to be, the de facto decentralisation was not achieved through monetary means. Multi-purpose money was not essential for the development of an extensive division of labour, as it has been for market economies (Hicks, 1968). The socialist economies were in this sense ‘natural’ economies. The issues involved when transforming a ‘natural’ economy into a market economy have been a central subject for both social science and economic history for long, most often associated with the names of Karl Marx and Karl Polanyi. The transformation they considered was one of agriculturally based peasant or feudal economies, all decentralised, into market-based systems. The issue here is a transformation of a single economic bureaucracy with a public ownership structure into a complex of markets and private, portioned capitalist ownership structures. Like the historically preceding transformation, both the new and the old order were sustained by differing norm systems. The shift in norm systems opened up for some forms of corruption. One important difference between the transition from socialism to capitalism and the one from ‘feudalism’ to capitalism was the immediate feedback effects which the signal of system change had on the old order. The swiftness of the response was in this case related to the highly centralised character of the old order’s production system. The most striking feedback effect was the bureaucracy responding with a production decline.

As just mentioned, an important characteristic of both kinds of transitions, has been the ‘monetarisation’ of the economy, a somewhat vague, but nevertheless important process. In the terms of Polanyi, as a consequence of the transition to a market economy the ‘special-purpose money’ of the socialist economies would have to change to the ‘all-purpose money’ of the capitalist market economies.³

Hence, it may not be so surprising that a number of issues that arose in the transformation of peasant or ‘feudal’ economies into capitalist market economies have reappeared in the transition from socialism. Old analyses of Marx and Polanyi have present relevance for reasons they may not have imagined, a relevance they hardly would have hoped for.

Before the transition, corruption was apparently stimulated by the growth in irregular or illegal markets. That is not so surprising. The widening of the number of such markets increased the number of goods and services money could buy. What is more surprising is that the later legalisation of a large number of market processes did not bring corruption rates down. During the transition the incidence of corruption even appears positively related to the legal expansion of market forces. That also happened in the countries where the communist party kept control, such as in China and Vietnam.

In the first part I outline some of mechanisms shared when markets expanded in the socialist countries with and without communist party breakdowns. Mainly observations from the Soviet Union before and after the party breakdown will be used, however. I indicate how both legal and illegal expansion of regular markets contributed to increase both the corruption and the need for more powerful monitoring mechanisms. While the last challenge was partly met in China, in the Soviet Union it was not. In fact, the market expansion nexus might have been one

3 The term ‘all-purpose’ is, of course, an exaggeration. If we have money at the left side and a complete list of goods and services deliverable in a society on the right side, no society would allow money to buy every item on the list. The length of the list of items which money may buy determines the exchangeability of money. Even with respect to market economies the lengths of that list may vary considerably. Regular corruption extends the list. For shortness I often call this money ‘cash’, although in most case cash refers to bank deposits where the owner is not subject to extensive restrictions.

of the major mechanisms triggering the party breakdown. Since party breakdown is only an exogenous fact in the study, no separate analysis of it is made.⁴

As emphasised by Kornai (Kornai 1992:361) the communist party and its ideology is the key to understand the workings of the centrally planned economies (the CPEs). Whether the communist party of a country broke down or not, was the crucial determining factor in staking out the different paths of corruption that followed in the wake of their market expansions.

Here I also stick to a Polyanyi perspective in the methodological sense by regarding present levels of corruption in the post-communist countries as the outcome of a particular historical process, restraining the possible counterfactual experiments to be allowed as explanations⁵.

Corruption as market intrusion into the spheres of hierarchy and polity

Regard the following definitions of corruption and embezzlement (Andvig, 1995):

An act is *corrupt* if a member of an organisation uses his/her position, his/her rights to make decisions, access to information, or some other of the resources of the organisation, to the advantage of a third party and thereby receives money or other economically valuable goods or services in ways that either are illegal or against the organisation's own aims or rules. An act represents *embezzlement* if a member of an organisation uses his/her rights to make decisions, access to information or some of the other resources of the organisation to his/her own economic advantage, eventually to the advantage of some other members of the organisation, in ways that are either illegal or against the organisation's own aims or rules.

Corruption then implies that a person outside the organisation in question buys a certain favour (which may be to refrain from illegal punishment) from an insider

4 For an interesting and extensively research study of the breakdown of one monitoring organisation in the former Soviet Union, the Komsomol, see Solnick (1998). His study traces an extraordinary important monetarisation of key political organisations of the old order..

5 Shleifer and Vishny (1993) apparently agree with many of our conclusions when they are insisting that centralised corruption (such as the one that existed in the communist countries before the party breakdowns) is less harmful to growth than decentralised corruption, which a state breakdown will easily lead to. Their modelling, as Harrison and Kim (2002) point out, does not give scope for the peculiarities of the planned economies. Moreover in some post-communist countries, such as Azerbaijan, corruption became quite centralised after 1993 while its production decline was among the heaviest, and corruption appears to be at least as harmful as the one where it became more decentralised. Being a set of static models, there is no mechanism in them which leads from the monopolised to decentralised corruption.

who sells it, i.e. regular, repetitive corruption implies that the set of market transactions expands illegally into the fields of bureaucratic and political decisions. Embezzlement does not, however, imply market expansion, but it too represents a misuse of a formal position for private gain, is stimulated by any weakening of an organisation's monitoring apparatus and is also in other ways likely to be stimulated by many of the same set of circumstances as corruption. Because of the importance of privatisation during the transition embezzlement has proved as important as corruption in several of the post-communist countries, as it certainly has been in Russia. Since embezzlement may be performed by a single member it is often easier to perform, hence it is also likely to be more frequent in low corruption environments.

The notion of corruption indicates that agents uphold norms about the ways transactions between agents should be performed. Most societies seem to have a limited number of such norms about transactional modes and the meta-norms for determining the situations of which they may apply. In particular, transactions which are stipulated to be task-oriented, loyalty-oriented or rule-bound, i.e. bureaucratic transactions, should not be performed in the market mode. Task-oriented transactions are transactions where the immediate motivation of the individuals involved is simply to solve the task. To be able to solve the task becomes its own incentive.

Large-scale changes in economic systems normally imply large changes in the fields of application for these various micro-coordination devices both from a normative and a factual point of view. For example, one of the key characteristics of the socialist societies compared to present OECD countries was that their normative grids allowed a much smaller space for market transactions.

Traditional socialism and corruption: Hard bureaucratic and soft market incentives

A well-known characteristic of a CPE was that the whole economy was organised as one public bureaucracy. Unlike most bureaucracies, the main thing shuffled across offices (enterprises) was not messages, but real goods and services. Like in

any standard bureaucracy there were no hard price charges as long as the movement of goods and services was internal to it. The prices attached were mainly accounting devices useful for reporting, but not so important for behaviour. Only the goods leaving the bureaucracy for private consumers were paid in cash, while bonuses and wage expenses were the only items paid out in cash.

At the higher levels the central problem was to coordinate the various offices so that their plans for delivery and acquirement meshed. In order to do so, the specification of the transaction technology, which office to communicate with whom about what, was exceptionally important so that the higher levels were not overwhelmed with information. In theory the economy was coordinated by a production and delivery plan.

In practice the old planned economy was more like a kind of multilateral bartering system where the subordinate offices had to do much of the searching themselves. The coordinating sectors, while not dealing in planning in the strict sense, nevertheless had an important role to play by actively reducing the large search costs involved. Unlike regular market economies, most of the search costs had to be shouldered by the acquiring, not the delivering agents. Prices, fixed by the government for long periods, played only a minor role in coordination, mainly because budgets were not decentralised. The output prices did not constitute a basis for income to be spent, only income in the books.

This does not mean that the offices (enterprises) were completely uninterested in their prices. Higher (accounting) prices implied in most cases an easier life either because that eased plan-fulfilling directly, or because increased prices would increase the value of the bank accounts of the office, which it somehow might get access to (granted the necessary permissions). Such prospects even increased the ease by which it might get access to inputs outside the regular channels⁶. Regarded as economic incentives, prices were soft, however. Profits

⁶ Harrison and Kim (2002) present an analysis of how enterprises exploited the fact that the binding output plans had to be so aggregated that they never were fixed in physical output terms, but in value terms. Accounting prices were needed for that aggregation. Given this situation, they convincingly argue (against Shleifer and Vishny (1992)) that the enterprises were always interested in 'high', not 'low' prices, and that they had some scope for influencing the actual delivery prices. In the model they study the interaction between accounting prices, the actual delivery prices, production levels and, eventually, corruption under the old regime. However, they don't focus on the situation when the prices carry income

were a somewhat stronger incentive, particularly when bonus payments were tied to profit targets, but still soft. To make a large positive profit made life easier, but after a while it would be taxed away. Negative profits were undesirable, but did not threaten survival. While high taxes were negative seen from an enterprise's point of view, it made not much sense to invest much effort in avoiding them, since the enterprise had little alternative use of the profits. Tax incentives were also soft.

The hard incentives were bureaucratic. In the short run the strongest was simply the task-oriented *plan fulfilment*. If you did not fulfil the plan, you brought your superior and sometimes also your workers into trouble. A large part of your own income hinged upon plan fulfilment through bonuses (often 60–90%, Conyngham 1982: 19). The analytical discussion of the operation of the Soviet incentive system has accordingly focused on bonus maximisation and the so-called *ratchet effect*. The choice of plan indicators to tie the bonus to changed constantly, particularly since the mid 1960s. A major point was, however, that bonuses were awarded according to some indicator of plan fulfilment, not absolute achievement, such as realised levels of production. If the enterprise/offices over-fulfilled the plan, the plan was adjusted upwards next year. This implied that the officials would try to supply as little output, and demand as much input, as possible. The passive bonus maximisation behaviour with the ratchet effect was a go-slow equilibrium where either the probability of promotion was low or promotion was based on this same passive plan fulfilment. Here it never paid to be a hard-working enterprise. Naturally, when generalised, most sectors would then experience excess 'demand'.

Even in this situation to assume bonus maximisation behaviour could be misleading. The bonus actually received was always in part influenced by informal considerations. Readjustments of plans were continuously made. It was well recognised that strict application of any given bonus criteria would always give rise to abnormalities.

generating tasks (Johansen, 1978: 57) and how that fact change both the incentives and possibilities for making corrupt transactions, the main theme here.

Moreover, both expected bonus and the expected nature of task-solving would hinge upon the position occupied. The short-run bureaucratic incentives of task-solving and bonus maximisation would be embedded in the even harder bureaucratic incentives of career strivings.⁷ Since the capitalist road was closed, moving up the hierarchical ladder was the major path to become (modestly) rich.. Corresponding to the fear of losing wealth was here the ever-ruling fear of losing your position.

The mechanisms for promotion, the hiring and firing, were also important from a coordination point of view, since they represented an enormous saving of informational costs of steering. Although management positions in countries like the Soviet Union were numerous, the number of significant economic choices that in theory should be coordinated through an explicit plan was by far much higher, since each person had some kind of structure making his actions auto-correlated from the leadership's point of view.⁸ It was much easier to control individuals through personnel policies than to control all their actions through extensive formal control systems tied to output deliveries.

This explains why the *nomenklatura* system became so important in the centrally planned economies, why the communist party's control of hiring policies was so important. The communist parties functioned as capital 'markets' of the socialist economies by shifting the leadership teams of the enterprises. By a further analogy to a stock exchange – it was through their exercise of this function that the communist parties became the effective owners of their countries' capital stocks.

The lever of personnel policies meant that that the stagnant effects of the ratchet games could at times be partly overcome. Nothing hindered the communist

7 Granick (1980) claimed that the enterprises in the Soviet Union should not be considered as any maximising unit at all. The ministry should, since that was the lowest unit where plan targets were normally kept constant during a year. His data for the period 1969-77 show indications of a shift from 'taut' planning in the preceding period to a softer strategy.

8 The novel *The Appointment* by A. Bek gives an example from the Stalin period. The extremely righteous manager O. discovers that A. is illegally (it is World War II) bringing some butter back home, which is only allowed to be eaten in the canteen, but A. refuses to tell why he did so and O. fires him in public. Afterwards O. discovers that A. had been asked by O.'s wife to carry the butter out of the canteen for the benefit of O.'s child. Since then O. brings A. with him to new positions on the assumption that A.'s display of loyalty will carry over in the new positions. The same applies, of course, with other bureaucratic virtues such as being hard-working.

party watching the actual growth of enterprises and its promoting successful managers to unlock the bottlenecks created by the stagnant ratchet games. When a sufficient number of offices realised that hard efforts were the key to promotion, the economy could move into a fast equilibrium. To play the stagnant ratchet game could then even prove dangerous for your health as it happened frequently in the Stalin period.. Note that even in the fast equilibrium excess demand and shortages were likely to arise since the promotion drives did not only work on the A rough indication of the economic role of the promotion policies of the communist party is growth rates. Economic growth rates of the Stalin era were generally high. The Stalin bureaucracy was newly established and fast growing (i.e. job openings were many and the likelihood of promotion high). While all the killings of the period created fear and destruction of manpower, they also renewed promotion possibilities. When the system was introduced to several new countries in Eastern Europe in the early post-World War II years, growth rates were also high and promotions frequent. While other factors clearly were also working, it is a striking fact that economic growth during the Brezhnev era declined as the promotional mobility decreased.⁹

Unlike the state economic organisations of the CPE countries, which were built on functional lines, the communist parties were based on geographical subunits, each with a large number of cross-sector responsibilities. From a corruption point of view it is important to note that the Party was not supposed to be much involved in day-to-day operations. It was organised formally as outside the state apparatus. In addition to its nomenklatura function it was also responsible for a general political and economic monitoring of the various institutions within its area of responsibility.¹⁰ It had therefore a right to get involved at different

9 Downs (1967) made a brief application of his notion of rigidity cycles to the Soviet Union (which is somewhat similar to our explanation), and predicted a slow-down before the real slow-down of economic growth had taken place. Documentation on high plant manager turnover from the Stalin period is in Berliner (1952). Public recognition of a considerable slow-down in turnover is documented at least from the mid 1970s (Conyngham 1982: 17). The fragility in the workings of the Soviet economic bureaucracy has also been noted in Harrison (2001).

10 The party monitoring of large economic units located in a particular geographical subunit was normally the responsibility of the party leadership of a larger geographical unit; in the case of the largest enterprises the Party at the national level. The party leadership inside an institution was in general partly subordinated to the CEO of the institution, and partly to the local party leadership. The last tie was the stronger one, a party insider often acted more like an informer who would send information about the CEO of the enterprise to the party nomenklatura employing network.

hierarchical levels of the state organisations. The Party itself was monitored by separate monitoring organisations like the KGB. Although monitored, the Party remained the key power-holder, probably directly and indirectly linked to its employment function. It was these structural features, growing from the Party's role as the ultimate power-holder, which allowed it to establish local networks of personalised information gathering and to function as a capital market.

How exposed to corruption were the CPEs, what was the extent of corruption and its major forms? I find it useful to distinguish between corruption *internal* to the economic bureaucracy and corruption at its *borderline*, where it met the citizen-consumer, i.e., areas of activity where cash transactions were common. Let us first look at the internal corruption.

In the high-speed equilibrium the tautness of plans 'forced' the managers to break rules in order to achieve plan fulfilment. Since one would experience excess demand whether the bureaucracy was playing slow ratchet games or followed the hard Stalin promotion rules, it would be the 'buyer' who would have the incentive to bribe, not the seller like in a capitalist market economy. So one step to obey the plan could be to bribe an input supplier. In most cases the method used was not corruption in the strict sense, but rather pulling strings of influence of a more personal or political nature, *blat*. Furthermore, the formal breach of the plan was more often than not made in order to fulfil the aim of the organisation, not to further the private interests of the involved parties¹¹.

A major mechanism for containing corruption of the internal kind, was the non-monetised way of allocating of goods across enterprises. The income received by a supplying firm could not be spent at will, but showed up only in its ledgers at the mono-bank. The share of 'cash' that an enterprise could hide away from its planned wage and bonus allocation was not sufficient to buy significant amount of inputs (i.e. bribes). Instead, one had to rely on the channels of influence mentioned easing illegal or semi-legal multilateral barter deals. Particularly for the input-producing parts of the economy, the transaction costs for completing

¹¹ Harrison and Kim (2002) have modelled this situation. In their model they show that in general more corruption is to be expected in the less harsh equilibrium.

corrupt deals were so high and the expected private gain from bribing was so low that the evolution of large-scale commercially motivated corruption was to a large extent contained (Andvig, 1985). While planning could sustain a complex division of labour, by not being monetised, it was difficult to achieve that double coincidence of wants necessary to complete a purely corrupt transaction. It was constantly sought achieved, however, through a combination of bending some rules to get initial access to some real, scarce goods and looking for people who might be able to have use for them.

It was of course not impossible for agents with large cross-sector networks – party officials were here often in good positions – to complete longer strings of barter deals often necessary to complete successful corrupt transactions. Informal norms supporting long-lasting obligations of a ‘debtor’ of a favour to eventually close his open-ended credit positions by a return favour also increased the scope for internal corrupt deals (Ledeneva 1998). Nevertheless, the lack of, or rather the strict control of cash in the socialist economy acted as a brake on the expansion of corrupt deals.

The obvious implication is that any increase in the scope of monetary circulation, any rise of markets in the producer goods industries should also tend to increase the incidence of internal corruption. The Polanyi perspective becomes visible: The growth of market forces on the basis of a ‘natural’ economy would have important feedbacks on the old order..

At the borders of the socialist administration cash was in use and transaction costs much lower. Since shortages and excess demand situations also ruled the consumer goods markets, but their prices were determined in the plan, paying shops under the counter for getting better quality goods, getting ahead in a queue or simply to get access to a scarce good was common. Given the rules and norms of a socialist society, this was corruption. Disregarding situations of rationing, seen from the point of view of a market economy, this was morally rather harmless activities and would hardly be counted as corruption.

Other public officials, not being shop employees, but who were meeting the public could also make corrupt deals with low transaction costs: Doctors, police-

men, judges, teachers, policemen, university professors, and so on. Given the severity of the penal system, it was not surprising that corruption in the courts and among the police has been considered to have been a major problem in the Soviet Union.

While embezzlement was taking place at the enterprises both internal to and at the edges of the bureaucracy, in general the incentives to embezzlement were also stronger at the edges since these were easier to either barter or sell. However, some inputs were tempting to embezzle everywhere, such as gasoline. The incentives for getting cash allowance for non-existent workers, the 'Dead Souls' of socialism, while not easy, were equally strong everywhere.

The Soviet road to reform: The softening of bureaucratic and the hardening of market incentives

Corruption increased in the Soviet Union the last two decades or so of its existence, most observers agree. However, we have to be careful before we draw any conclusion about the underlying reality on the basis of these *perceived* increases. As pointed out by Holmes (1993: 4–5), in the early 1980s a large number of anti-corruption campaigns were taking place in a number of socialist countries. The underlying reason was probably a belief that corruption itself had become more severe. However, the fact of the campaigns increased the public's awareness of corruption as an issue. The same did the fact that several leading politicians in the Soviet Union climbed up the ladder of the communist party as corruption fighters (Andropov, Shevardnadze, Heydar Aliyev) and major power struggles, such as the Brezhnev succession, were fought around corruption accusations (Clark, 1993, 145–201). The public's perception of an increasing rate of corruption was unavoidable.

In this case I believe it was rooted in facts. Since no indexes of corruption were available at the time, evidence has to be sought in roundabout ways: Judgments about the likely effects of changes in economic policies or in the political and economic structure on corruption; observations of other variables linked to corruption, particularly the size of the second economy; the number of newspaper

stories about corruption (Holmes 1993: 137) or the number of people convicted for economic crime including corruption (Clark 1993: 87). Many stories of more or less anecdotal kind support this impression. Of particular importance are the stories of large-scale corruption such as the famous Uzbek cotton scam, since it is almost prohibitively difficult to organise a large number of people in a network of corrupt transactions in low-corruption surroundings. Thus, a single story may have strong implications for the quantitative assessment of the situation.

How could corruption increase in the centrally planned economy at the time of Brezhnev? Was it related to the softening of the bureaucratic regime, the reduced tautness of plans or rather in the expansion of market forces? Or maybe mainly through the interaction of these two developments? If so, how? Let us first look at the internal corruption. Here the softening of bureaucratic incentives that followed in the wake of less stringent monitoring was crucial. We have mentioned that the plans became less taut, punishment of unsuccessful managers became less harsh, the pressure from bureaucratic customers less insistent, since they themselves were under less pressure. This made it easier to set aside unused inputs, to develop spare capacity and play the ratchet game successfully. Note, however, that the bureaucratic incentives for having spare capacity were still limited as the enterprises had no control of their intra-planning income, nor were they able to sell the unregistered output outside the plan in large quantities. During the Brezhnev period no real decentralisation of income spending decisions at the enterprise level took place. The expansion of market forces was mainly taking place outside the official economy.

Being outside the legal economic apparatus, buying and selling in black or grey markets were clearly illegal, but not necessarily corruption. Consider the example of a state farm keeping aside a considerable amount of its wheat harvest to make vodka, selling it illegally in a local market. The supply of that vodka would represent embezzlement. In order to get away with it, however, the state farm would have to engage in *borderline* corruption, bribe the local police, party authorities, and so on. If middlemen were needed for its distribution, they would have to do the same. A lax plan might be sufficient for making that embezzlement possible.

This farm would now have a much stronger incentive for not revealing its capacity than the former desire for easy life. It had a clear incentive to try to bribe the plan authorities to get more slack, and the sale of illegal vodka gave the farm the means to do it without great transaction costs, i.e., *internal* corruption was stimulated. The impulse to corruption may spread inwards from the border: The farm may need new equipment for making vodka, and order it from a boiler-maker. This delivery should better be kept outside the plan, i.e., the boiler-making enterprise also got a stronger incentive for hiding capacity. The boiler-maker can be paid in cash, and had now instruments for paying bribes further back, if needed.

The increase in the second, market economy has now also stimulated internal corruption. That corruption tended to decrease the output delivered in the planning channels and to increase the supply to the second economy. The influx of harder economic incentives at the enterprise levels increased the strains on the monitoring apparatus both directly through corruption and indirectly by giving the enterprises stronger incentives for hiding capacity.

While the increase in corruption is not well documented, the expansion of black or grey markets is. A clear quantitative indication of the increasing size of the second economy is presented in Treml and Alexeev (1993). They show that the statistical correlation between official income and savings, and income and the registered sale of important consumer goods weakened strongly in the period between 1965 and the late 1980s (even for alcohol). A reasonable interpretation of these facts is that a larger share of both the households' income and consumption originated from unofficial sources. By looking at the geographical distribution of the size of the second economy and the rough indicators of corruption we also note a rough positive co-variation:¹²

12 Note that the estimates of the second economy apply assumptions that force some artificial equality across some areas. The 'control of corruption variable' is an aggregation of corruption indexes made by a number of organisations, the aggregation performed by World Bank researchers (Kaufmann et al. 2002). It mainly reflects the perception of corruption held by businessmen and experts. The post-breakdown observations of corruption are included here partly from a belief that there will be some persistence in corruption and second economy levels across the regime change.

Table 1. Corruption and second economy. Estimates before and after the transition in some former Soviet Union countries

	Conviction rates per million popu- lation 1965–1990	Control of cor- ruption 1997/98	Unofficial economy share 1979 (%)	Unofficial eco- nomy share 1995 (%)
Country				
Armenia	7.27	-0.80	...	...
Azerbaijan	21.85	-1.00	50	70
Belarus	0.20	-0.65	43	35
Estonia	2.14	0.59	22	22
Georgia	15.00	-0.74	50	71
Kazakhstan	1.21	-0.87	50	50
Kyrgyz Republic	3.85	-0.76	...	...
Latvia	0.00	-0.26	34	41
Lithuania	1.41	0.03	34	31
Moldova	4.63	-0.39	43	48
Russia	2.81	-0.62	27	46
Tajikistan	2.00	-1.32	...	...
Turkmenistan	4.06	-1.29	...	...
Ukraine	1.70	-0.89	38	57
Uzbekistan	2.71	-0.96	50	29

Sources: Clark, (1993, Table 3.5), Kaufmann et al. (2002, Table2), Alexeev & Pyle (2001, Table 5-6).

It confirms the time series observations of a simultaneous rise in corruption frequency (more published corruption stories) and the size of the second economy since the mid 1960s.

What about the role of the communist party in the growth in the corruption and the second economy during the low-activity equilibrium? Regarding the *internal* corruption and the communist party's general monitoring role, the effects appear uncertain. At the one hand, the possibility of skimming off money when arranging

multilateral barter deals would increase with increased injections of uncontrolled money; on the other hand, the enterprises' increased holdings of such money should make less need for the complex multilateral barter deals corrupt, but loyal¹³ party officials were in a unique position to make.

With respect to borderline corruption, however, there can be no doubt. Allied with purely information gathering institutions like the KGB or local policing units, communist party leaders could here cash in on their monitoring role. Considerable local returns to scale were present, so the corrupt income opportunities in areas with high incidence of second economy activities such as Azerbaijan or Georgia, also opened up possibilities for large-scale Party corruption. Borderline corruption could make some communist party members rich.

Regarding the other main activity, the nomenklatura employment function, the effects were probably even more uneven, and threshold effects were likely. By itself the stagnating mobility of the Brezhnev period should reduce the value of the employment function, but reduce the transaction costs of employing it. In the Stalin era the value of promotion (or the value of avoiding a death sentence or a prison camp) would evidently have been high, but the ability of potential managers to pay up front for a promotion would be very limited, given the cash control, so Party members' ability to generate bribes on the basis of their employment function was probably modest. However, a lowering of pressure without cash injections should reduce it even further.

With the expansion of an illegal, second economy, and less stringent cash limitations, that would change. When our vodka-producing state farm manager became rich, his nomenklatura board would realise the value of the position. Then the position could be auctioned. Adding the value of such auctions to the stream of bribes related to the general local monitoring, local Party leadership positions may become quite lucrative, indeed. The communist party's potential role as a capital market in fact became visible in the regions of USSR with high second economy rates. It even became two-tiered: According to Simis (1982: 36), at least

13 Loyal here means that the party officials sanctioned the breaking of rules, including the rise of stocks of unauthorised stocks in cash in the hands of the enterprises in order to make them better able to fulfil the plan, not in order to fill their own private pockets.

from the early 1970s there were fairly open auction sales of ministerial posts in Georgia and Azerbaijan with separate prices for access to the bidding process (nomination) and the actual position itself. In the first tier state leadership positions could be bought and sold, in the second one, the access to the positions where leadership positions could be sold became themselves open for sale. This is, of course, only a stylised description. The actual outcomes were determined by a mix of bid size, clan membership and communist party politics.

One way to avoid the illegal expansion of the second economy with its effects on corruption was to legalise it. However, the intensified incentive to hide did not disappear when the enterprise could sell part of its product legally on a market, as it happened in China and, copying China, the Soviet Union after 1987. The increase in scope for the market mechanism at the enterprise level not only increased the demand on monitoring of production planning, but also the demand on tax authorities and price-fixing authorities. The Chinese party managed to handle the strain on its monitoring, although the creation of a parallel market and planned economy created considerable corruption in the Chinese case too. In the Soviet Union the bureaucracy was already weakened, the monitor-demanding decentralisation of income of the 1987 reform created serious problems and was not fully implemented. The Party's ability to monitor was further weakened in 1990 when managers were supposed to be elected by an enterprise council instead (Jeffries 1993: 54). The communist party thereby scrapped its key lever, the power to employ the managers.

Political breakdown, monetarisation and corruption

One year after the Communist Party of the Soviet Union had yielded its nomenclatura rights, it lost its state-holding powers, as had happened with the other state-holding communist parties in Europe before. By then it became clear that the area economically would be ruled by market-based organisations. The speed, exact scope and organisational patterns were not settled, but *that* the scope for market transactions should expand, was clear. The scope for hard economic incentives

and cash money would increase in a setting where the public monitoring capabilities were shrinking.

As soon as the enterprises were allowed access to markets on a larger scale, their casual attitudes to prices and taxes did change drastically. The switch from soft to hard prices (first partly illegal) which followed the partial price liberalisation made it difficult for both the workers of the enterprise and the weakened communist party to prevent the transfer of enterprises' new, hard income into the managers' private accounts.¹⁴ From the flow side each enterprise tried to keep its expenses in soft prices and its income in hard. Deregulation of foreign trade meant that income from exports became exceptionally attractive. Strangely, some expense that had been hard before, such as wages become soft for a while, probably reflecting the changing power structures.

The emerging income-earning aspect of prices released a cost-push inflation mechanism since the enterprises now had gotten a strong interest in the prices of their products, were allowed to fix them (in Russia from 1992, after the price liberalisation) and many were in position to increase them. To some extent the cost-push mechanism could be self-sustaining, but it was in fact working together with the large monetary overhang of the Soviet Union at the point of the breakdown.

How large the money stock was at any given time, is a rather complicated matter to decide, due to the stock aspect of the monetarisation; the gradual lifting of restrictions on various bank deposits, increasing their liquidity. It stimulated extensive efforts to shift the inter-enterprise credit and debt positions: Each enterprise would try to keep its debts soft and credits hard. The resulting patchwork of hard and soft positions, soft and hard debts, strongly stimulated enterprises to compete through bribes in making authorities sanction desirable shifts in the hardness degree of the debts and credits. Enterprises (or organisations) that received early access to hard credits, such as an early lifting of restrictions on bank deposits, could gain a decisive advantage. Several of the largest private banks in Russia grew from the lifting of the restrictions on Komsomol's assets

¹⁴ Before the privatisation of the enterprises, this kind of behaviour was clearly a case of embezzlement. Since then, it may be considered as a way of defrauding minority owners according to the new rules of the game.

(Solnick 1998: 119). The strong shift in relative prices that was also part of the outcome of the combined lift of price and income disposal restrictions, contributed strongly to the overall production decline that took place in the later stages of the transition.¹⁵

The monetarisation of taxes had immediate impact on corruption rates. The traditional tax-collecting apparatus was geared to a situation where the incentives of tax avoidance were weak. That changed dramatically when the taxes to be collected were supposed to be in hard money. The amount collected plunged. The enterprises now had strong incentives not only for tax avoidance, but for bribing tax officials, which they did on a large scale. This caused a further tax decline, and an immediate rise in the overall corruption rates. Softening the impact of monetarisation, some tax debts were kept soft for a while. In addition, many enterprises moved into the informal economy in order to avoid taxes altogether. This reduced taxes further and was also likely to increase the corruption rate. In most cases it was necessary to bribe at numerous points of the public administration to survive as an informal enterprise.

The effects of monetarisation on aggregate tax collection were reinforced by the production decline, reducing the tax base further. The spillover effects from corruption in the tax collection authorities to the other public sectors were strong, since the need for most public services were unchanged or rather increasing. One result was an income squeeze which made the single public employee responsible for collecting his own private taxes or sell his services piece-rate, i.e., to extort or bribe. Azerbaijan was an extreme case. While in 1992 public budget revenue constituted 61.5% of GDP, in 1997 it was only 17.4% .¹⁶

15 The effects of the whole disorganisation, including the strong price shifts, on production levels have been nicely analysed in Blanchard and Kremer (1997). Some of the production decline was halted by the rise of the clusters of multilateral bartering clusters. According to the new set of relative prices many of the enterprises which would have a positive (accounting) profits, could now only operate with negative profits, and would have to close if all prices remained hard. However, clusters of such enterprises were able to survive when some of the inputs received were charged only in soft prices. From a Polanyi point of view they could be considered as attempts by the producers to withdraw from new market forces, in order to survive, to protect the old 'natural' economy. Unlike former-day peasants Soviet workers could not to do on an individual basis, however. Clusters of enterprises were needed. Their effects on the average corruption rate are uncertain and rely heavily on the counterfactual to be specified.

16 Andvig (1999: 42). The experiences of the different post-communist countries with respect to tax collection were very different, however. In some taxes have increased. The preceding discussion on monetarisation applies most directly to the area of the former Soviet Union, which had had less

Production decline, political shocks and corruption

The most dramatic and visible expression of the breakdown in the control of the communist parties was the decline in production. Since production was organised through the all-embracing bureaucracy, where the outcome of each office's effort hinged upon the effort of the others, that was to be expected. Bureaucrats were in fact told that their employer (monitor) was gone, together with the bureaucratic rewards, such as the prospects of promotion. Any relation between enterprise effort levels and individual economic rewards had become highly uncertain and difficult to predict. Neither is it surprising that the disappearance of the established monitoring apparatus also encouraged corruption.

An indication of the strength of the corruption – production-fall connection is presented in Table 2.

interaction with market economies and where the planned economy was more extensive than any of the smaller member countries of COMECON.

Table 2. GDP, corruption and production decline in post-communist countries

<i>Country</i>	<i>Cumul-ative output decline to lowest level (1989 = 1000)</i>	<i>Government effectiveness, 1997/98</i>	<i>Government effectiveness 2000/2001</i>	<i>Control of corruption 1997/98</i>	<i>Control of corruption 2000/01</i>	<i>Capture econ-omy index</i>	<i>Admin-stra-tive corruption % of revenues of all firms</i>
Albania	399	-0.65	-0.89	-0.99	-0.60	16	4.0
Armenia	651	-0.65	-1.03	-0.80	-0.80	7	4.6
Azerbaijan	631	-0.83	-0.95	-1.00	-1.05	41	5.7
Belarus	369	-0.66	-0.99	-0.65	-0.06	8	1.3
Bulgaria	368	-0.81	-0.26	-0.56	-0.16	28	2.1
Croatia	377	0.15	0.10	-0.46	-0.02	27	1.1
Czech Republic	154	0.59	0.58	0.38	0.31	11	2.5
Estonia	364	0.26	0.86	0.59	0.73	10	1.6
Georgia	746	-0.51	-0.72	-0.74	-0.69	24	4.3
Hungary	181	0.61	0.60	0.61	0.65	7	1.7
Kazakhstan	400	-0.82	-0.61	-0.87	-0.83	12	3.1
Kyrgyz Republic	504	-0.58	-0.61	-0.76	-0.85	29	5.3
Latvia	528	0.07	0.22	-0.26	-0.03	30	1.4
Lithuania	408	0.13	0.26	0.03	0.20	11	2.8
Macedonia, FYR	466	-0.58	-0.63	-0.52	-0.51	...	...
Moldovia	663	-0.46	-1.10	-0.39	-0.83	37	4.0
Poland	136	0.67	0.27	0.49	0.43	12	1.6
Romania	267	-0.57	-0.54	-0.46	-0.51	21	3.2
Russia	451	-0.59	-0.57	-0.62	-1.01	32	2.8
Slovak Republic	247	-0.03	0.23	0.03	0.23	24	2.5
Slovenia	204	0.57	0.70	1.02	1.09	7	1.4
Tajikstan	740	-1.42	-1.31	-1.32	-1.08	...	...
Turkmenistan	595	-1.25	-1.23	-1.29	-1.12	...	...
Ukraine	638	-0.89	-0.75	-0.89	-0.90	32	4.4
Uzbekistan	144	-1.30	-0.86	-0.96	-0.66	6	4.4

Sources: Kaufmann, Kraay and Zoido-Lobaton(2002), Fischer and Sahay (2000)

We present two additional (to Table 1) corruption indicators. The capture variable gives the percentage of firms involved in corruption at higher levels. The bribe variable is self-explaining. It is evident from Table 2 that the initial production decline in the post-communist countries was a spectacular historical event. The

average production decline in the area which now constitutes 25 countries was above 40%, greater than even the great depression of the 1930s.¹⁷

Some of this co-variation must have been produced by the policy shock itself, by its weakening of the monitoring mechanisms and its sudden destruction of promotional capital. Corruption and production decline become two indicators of the strength of the same policy shock. A statistical exploration of the relationship shows that both the GDP level (negative) and the rate of production decline (positive) had strong, statistically significant effects on the corruption indicators (Andvig, 2002). In addition to the rather obvious simultaneous connection as two different expressions of the same breakdown of the communist party organisation, the decline of production and the *change* in norms and values had separate effects on subsequent corruption levels through economic mechanisms triggered on *after* the initial policy shock. Let us look at some.

First, the production decline itself caused corruption. Its effect through the intermediary variable of tax collection was obvious. Less clear-cut, but working in most sectors experiencing activity decline was what we may call the *Schumpeter effect*: The simultaneous experience of production decline and new, unknown institutional rules for operating, implied that many of the traditional activities in the centrally planned economies either became impossible or pointless to perform, a situation which had to shake the enterprises and public sub-hierarchies away from much of their traditional task-solving and rule-abiding transactions. In Schumpeter's famous theory, regular depressions in capitalists economies led to shake-ups that stimulated entrepreneurs to look for new, applicable technologies as means for economic survival. After a while, a clustering in time of such applications led to economic revival.

In the case of the even larger uncertainty of the transition, the shake-ups led to search for private personal (and enterprise) economic opportunities in an economic environment where agents were uncertain of whether they should stay with their tasks, follow bureaucratic rules or engage in friendship games. This uncer-

¹⁷ Fischer and Sahay (2000: 34). This number as well as the explanation of the production decline outlined in the following are controversial. It would make this paper too long to give a balanced overview of the competing and complementary explanations, however.

tainty often led to the dominance of the economic (survival) mood. Given the initial positions of many of the agents involved, this gave rise to a large number of corrupt transactions. That is the motivation part of the Schumpeter effect.¹⁸ Learning processes were also involved. Since the economic rules to a larger degree became questioned, being in flux, more ways to circumvent them were explored. Corruption is essentially a rule-breaking activity and in that sense often entrepreneurial in spirit. As corruption entrepreneurs discovered new ways to survive or become rich by breaking the rules, followers would join and the incidence of corrupt transactions increase.

While the Schumpeter effect of the production decline and its associated disorganisation and institutional reshuffling mainly operated on corruption as ongoing practices, the related *Huntington effect*, alluded to in the introduction, worked also strongly on the public's perception of the corruption issue. The Huntington effect relates corruption in fast-changing, 'modernising' societies less to the reshuffling of institutions, but rather to the reshuffling of norms. Huntington (1968: 60) vividly describes the effect:

Corruption in a modernizing society is ... in part not so much the result of the deviation of behavior from accepted norms as it is the deviance of norms from established patterns of behavior. the calling into questions of old standards ... tends to undermine the legitimacy of all standards. The conflict between modern and traditional norms opens opportunities for individuals to act in ways justified by neither.

This means that the Huntington effect partly includes a situation where the survival of *old* personalised *behaviour* occurs at the same time as *new* norms for public office are introduced, and partly describes an anomie effect caused by agents experiencing that two contradictory norms apply to a given situation. The

¹⁸ In several multiple equilibrium models of corruption such as Andvig and Moene (1990), widely divergent corruption levels are explained as the outcome of the same gain-motivated behaviour. Hence, by applying Occam's razor, the Schumpeter effect may be considered to be an unnecessary detour: Why explain a shift towards high corruption levels as a massive transition from task-motivated towards gain-motivated behaviour, when the same kind of transition might be explained as two equilibria among gain-motivated agents? The reason is simply that it is hard to imagine the low corruption equilibrium to be realistic for a population of gain-motivated agents.

assumption is that the agents then follow neither and respond by choosing the economic gain mode, which may be immoral according to both norm sets.

While the anomie effect was the same in the socialist transition case, the norm effect was different. Here it was *new* behaviour patterns that would be judged by the *old*, pre-transition norms as corrupt and hence give rise to a perceived increase in corruption. Since the OECD ideal allows a much larger scope for market transactions, many established practices would not be corrupt according to the new set of rules, so the actual level of corruption could go down while the perceived levels could go up, the opposite development of the one Huntington (1968: 59–72) was considering.¹⁹ If true, the anomie aspect is likely to have been important since they work like certain (internal) punishment. The penal code does not have the same effect since corruption is a low risk crime, as pointed out by Rose-Ackerman (1978) a long time ago,

Moral overshooting is an effect closely related to the Huntington effect. It is a hypothesis assuming active interaction between the two different norm systems: Since the new market economy allows so many new areas for gain-motivated actions considered corrupt by the old code, it must also be acceptable according to the new business-friendly code to buy and sell bureaucratic and political decisions. Why not?

Conclusion: The corruption legacy of communist party breakdowns

Former socialist countries have rather high corruption rates compared to countries that had comparable GDP levels before the transition. By constructing tailor-made counter-factuals it is possible, however, to bring their corruption levels back to normal (Treisman 2002). Some of these counter-factuals, as we argued in the introduction, such as the one where the absence of British rule is part of the explanation of the high corruption rates in the post-communist countries, are so artificial that it is difficult to consider them seriously as explanatory alternatives to

¹⁹ Roughly; Huntington discussed the transition from a family-based to a 'modern' economy where it was essential to make a clear normative distinction between the 'private' and the 'public' for officials in both the private and public sectors in modern society. The application of the old family practices in the new setting would imply corruption according to Huntington's definition. Hence an increase. If the old norms persist, corruption as perceived by the locals would not increase, exactly the opposite of our case.

a study of the policy shock and the process of transition, as focused on here. Missing reliable information about the actual pre-transition corruption levels, it is difficult to decide for certain whether corruption in fact increased or not as a consequence of legal market expansion and the communist parties' breakdowns.²⁰ While certainly not reliable, *perceptions* about corruption tell a more determinate story. Most opinion surveys show that the majority of people who have gone through post-communist transition experienced the new society to give rise to even more corruption than the one they have left, as indicated by the following table:

Table 3: Comparing the perceived corruption effect of the regime change (%)

	<i>Corruption has increased</i>	<i>Corruption is the same</i>	<i>Corruption is less</i>
Ukraine	87	11	1
FR Yugoslavia	81	17	2
Slovakia	81	15	4
Hungary	77	20	2
Russia	73	23	4
Bulgaria	71	25	3
Czech Republic	70	24	5
Belarus	70	25	5
Croatia	66	28	6
Romania	58	28	14
Slovenia	58	28	14
Poland	52	37	12

Source used: Rose (2001). Question asked: 'By comparison with the former communist regime, would you say that the level of corruption and taking bribes has increased?' The survey was done around 1997–98 except for Russia where the questions were raised in 1999–2000.

²⁰ See, however, World Bank 2001: Table 1 which indicates that actual corruption appears to have increased significantly in fact.

When Marx and Polanyi discussed the transition from a 'natural' to a market-based economy, they noted both the backwards-disrupting effects of the growth of markets on the old economy, and the painful experience of carrying forwards old economic practices and norms about proper economic behaviour into a system dominated by market coordination. One of the more disrupting of this kind in the post-communist transition was corruption. Whether the increase was mainly perceived or both a perceived and behavioural fact, extensive corruption is an important legacy of the post-communist transition.

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