

# **State Capture and Corruption in Transition Economies**

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## **Abstract**

State capture by industrial lobbyists is a significant obstacle to normal economic development of formerly command (socialist) economies, at both the local and the national levels. It is prevalent in transition economies because of an excessively concentrated industrial structure and low labour mobility, both horizontal and vertical, a high level of discretion of public officials in economic affairs, and generally weak political institutions. Most of these features might be traced back to the pre-transition legacy.

*Keywords: barriers to entry; command economy; corruption; decentralization; enforcement of contracts; mobility; local government; oligarchs; property rights protection; rule of law; special interests; state capture; transition and institutions; transition economies.*

In an ideal democratic society, citizens determine economic policy by a direct voting procedure or by selecting appropriate candidates at polls. In the real world, economic policy is affected either directly by self-interested elected officials or bureaucrats, or indirectly by special interests such as industrial lobbyists or even large individual enterprises. The actual channels of the (primarily negative) influence of special interests on economic policy are called 'state capture'. In most contexts, state capture necessarily involves 'corruption', that is, abuse of public office for private gain.

In any single instance of state capture, there are winners and losers. Typically, winners are politically important or simply large firms or whole industries and bureaucrats that receive favours from those firms. On the losing side, there are small, politically unimportant businesses, and, ultimately, the public interest and consumer welfare. For transition economies, the overall growth rate of the enterprise sector is estimated to be ten per cent lower in a capture state than in a state where the effect is less pronounced (Hellman, Jones and Kaufmann, 2003).

The principal characteristics of transition economies, as related to the issue of state capture, are an excessively concentrated industrial structure inherited from the planned economy, a high level of discretion of public officials with respect to economic policy, weak institutions of political control such as party system or independent media, suboptimal allocation of authority between government layers, and low labour mobility, both horizontal and vertical. In short, all of these factors might be traced to the command economy legacy, one-party political system, and legal system subordinated to political authorities, which were characteristic for most now-in-transition countries in the mid-1980s.

In transition economies, political channels that transmit information and, if necessary, money from firms and other special interests to politicians are not only less efficient but also less institutionalized. Furthermore, conceptualization of a specific exchange, both by parties to the transaction and by a student of transition, might vary widely. For example, what is considered as a fully legal lobbying activity or campaign contribution in an OECD country might be thought of as a bribe or even outright extortion in some other economy.

## ***Theory and transition specifics***

A bureaucrat's ability to extract bribes, the manifest form of corruption, is primarily determined by her ability to create rents by shaping the playing field for business (Rose-Ackerman, 1999; Shleifer and Vishny, 1993). In a perfect analogy with a monopolist's behaviour, if a certain kind of business activity requires obtaining a licence from a regulating body, the bureaucrat who is able to collect kickbacks for granting a licence has incentives to keep the number of licences issued less than socially optimal, thus increasing the 'price' of those licences that are actually issued. Furthermore, this provides incentives for bureaucrats to create new rent-seeking opportunities by introducing as much licensing and regulation as possible. A monopolistic bureaucrat sets a lower bribe level than a chain of successive monopolies, but the total volume of bribes is obviously higher, and so the impact on social welfare of centralized versus decentralized corruption is ambiguous.

Typically, special interests, through the channels of state capture, seek protection from competition such as barriers to entry to the local market. At the international level, protection usually takes the form of either import quotas or tariff protection. At the local level, it takes the form of licensing, small-scale regulation, and preferential treatment such as tax exemptions granted to individual firms. State capture, as a stable, long-standing relationship between existing businesses and incumbent politicians, has adverse effects on business and politics. In business, state capture prevents innovation by new or potential entrants, and, as a result, by the incumbent firms as well, and thus constrains market development. In politics, it decreases the chances of challengers to mount an aggressive campaign against an incumbent, which in turn reduces the electoral accountability of incumbents.

It is possible to further refine the concept of state capture. Hellman, Jones, and Kaufmann (2003), based on their econometric analysis of a large sample of firms in transition economies, argue that it is helpful to distinguish state capture from influence by special interests and administrative corruption, with each of the three forms of business involvement in politics having distinct causes and consequences. In this refined definition, state capture is the process by which firms shape rules of the game through semi-institutionalized bribes paid to public officials and politicians; influence is the same process without direct transfers (this category corresponds to costly 'informational lobbying' à la Grossman and Helpman, 2001); and administrative corruption encompasses all 'petty' forms of bribery related to law enforcement and regulation.

## ***Political power and economic power***

At the beginning of the transition, most of the political institutions that help to mitigate agency problems in the developed world such as independent courts and media, grass-roots political parties, and an institutionalized civil society were virtually non-existent. Inadequate provision of basic public goods such as property rights protection and enforcement of contracts, which are crucial for economic development, forced economic agents to seek alternative tools, for example by supplementing their productive investment with investment in private protection. For large businesses, state capture was a potentially powerful tool. In this view, bribes to bureaucrats or other forms of privately financed purchase of a public good becomes a strategy of an economic agent to increase efficiency and predictability in his business relations.

A specific feature of many transition economies, as compared with developing countries with a similar level of GDP per capita, is that they have been left with the remnants of the command economy with its highly centralized industry. The effect was more pronounced in industrially developed countries such as Russia or Slovakia, and less in countries such as Vietnam or Albania.

The existence of enterprises with very large employment levels produced a specific form of state capture. The managers of large enterprises, regardless of whether they were profitable, have a large menu of political instruments in their hands from which to choose. In particular, they could either rely on ties inherited from the times of the plan, or operate in a newly formed web of quasi-market exchanges including various forms of barter (Gaddy and Ickes, 2002). In Russian practice, quasi-market exchanges have often relied on government power to set individual tax rates and energy tariffs for enterprises. In the Hellman, Jones, and Kaufmann (2003) classification this often amounts to influence, not state capture, as government intervention is caused not by direct bribery, but by a complex chain of exchanges made possible by agents' participation in the same social network. The downside of this phenomenon is that inefficient enterprises are not driven out of the market, and at the same time provide political pressure to deter entry of new enterprises.

Proponents of 'big bang' reforms argued that establishing the rule of law, including institutions of property rights protection, requires the creation of a 'grass-roots' demand for the rule of law. In practice, it meant that the former state property should first go into the hands of private owners, and only then would those owners become natural proponents

of a system of property rights protection. With the high degree of concentration present in transition economies, and with undeveloped factor markets, this forecast (from private ownership to demand for the rule of law to property rights) has not been borne out. The rich – the beneficiaries of early privatization – have obvious incentives to protecting their property privately, for example via state capture. Consequently, they do not have incentives to lobby for the establishment of well-working state institutions such as independent courts or efficient bureaucrats. Instead, they seek to increase their political influence and modify the existing state institutions so that resources and wealth continue to be redistributed in their favour (Polishchuk and Savvateev, 2004; Sonin, 2003). (This is an example of how the Coase theorem is not valid when there are wealth effects.)

In Russia, the country that entered transition after the longest period of Communist rule, and was the most industrialized of the transition economies, a decade after economic reforms were launched most of the productive assets were concentrated in the hands of a few individuals, the so-called oligarchs (see Oligarchs). In part, it is an efficiency requirement that, when property rights are poorly protected, control rights over assets become concentrated: the larger a single owner's share is, the greater her incentives are to pursue improvements, such as in corporate governance. (Recent cross-country studies show that the worse the general protection and enforcement of property rights are, the greater is the concentration of control rights.) On the other hand, wealth inequality very often imposes heavy costs on the economy, primarily because it produces widespread inequality of opportunity. Still, the main problem is that the oligarchs who rely on state capture for protection of their property rights and enforcement of contracts do not form a natural constituency for the rule of law. This effect is especially strong when economic inequality is accompanied by underdeveloped democratic institutions, which is typically the case in formerly Communist countries.

### ***Decentralization and interjurisdictional mobility***

A critical check on the extent of state capture comes from institutions of federalism. The traditional approach to fiscal federalism focused on externalities in the provision of public goods that arise from preference heterogeneity in different jurisdictions. In the 1990s, a new approach emerged emphasizing the accountability of government officials (agency problems) at both the central and the local levels (for example, Qian and Weingast, 1997; see also Bardhan and Mookherjee, 2006). All former command

economies started transition with an overly centralized government structure, and faced the problem of optimal reallocation of economic and political authority.

The effect of decentralization on state capture is twofold. First, more authority allocated to the local level makes the agency problem at this level less prevalent, thus increasing accountability and reducing corruption. On the other hand, special interests might have much more influence over local government bodies; therefore, shifting authority downward might make state capture both more desirable and easier to achieve. In Bardhan and Mookherjee (2006) a reallocation of authority towards local government has a number of consequences. First, the amount of bribes collected by the central government decreases; second, local governments become captured by local special interests. Since local capture might be more easily supported by a social network, the total amount of bribes in the economy declines. However, since corruption at the central level is more money-based, the special interests are less entrenched than at the local level, and thus local capture brings more economic inefficiency. Ultimately, decentralization, while reducing bribe-based corruption measures, reduces economic efficiency.

Starting with Tiebout (1956), interjurisdictional mobility has been considered a major constraint on the local governments' power to abuse their prerogatives. When mobility is high and subjects can relocate from a jurisdiction with a predatory or hostile government, the local government's monopoly power over laws, regulation, and their execution is compromised. (See Slinko, Yakovlev and Zhuravskaya, 2005, for unique evidence on political capture at the local level.) Since the capacity to extract bribes is increasing in the bureaucrats' power to manipulate regulation, high mobility – of both firms and individuals – would force local governments to compete in providing a business-friendly environment. For a local government, the incentives to devote resources to, for example, fighting corruption, increase with the resources devoted by neighbouring governments.

### ***The endless transition***

In most transition countries, the transition from the command economy started in the late 1980s and early 1990s. It might be argued that most of the economic problems they face are no longer those of transition, but those of economic development.

Since the transition began, fear of the Leviathan state has been swiftly replaced by the fear of the capture state, where large and powerful businesses tilt the playing field

through bribery, media ownership, huge campaign contributions, and direct participation in politics. Lurid stories told about some extreme forms of capture, such as the use of corrupt secret service and police officers against business competitors, have crowded out images of millions perishing in forced-labour camps or dying in numerous famines caused by Communist economic management. There is a false sense of symmetry between the state manipulating its subjects and subjects manipulating the state: while the former has proved to be dangerous on a large scale, the second is a mere obstacle to economic development. There are several ways to deal with this obstacle. A backward-looking way is through restoration of the repressive capacity of the state. Another is through the development of political and civic institutions that may put a check on elected officials and bureaucrats, and through the institutionalization of business influence on politics in an efficient way.

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