Political Economy of Stalled Reforms

Powerful vested interests in some of the transition countries oppose further reform. But, even in this difficult climate, reform can and should continue.

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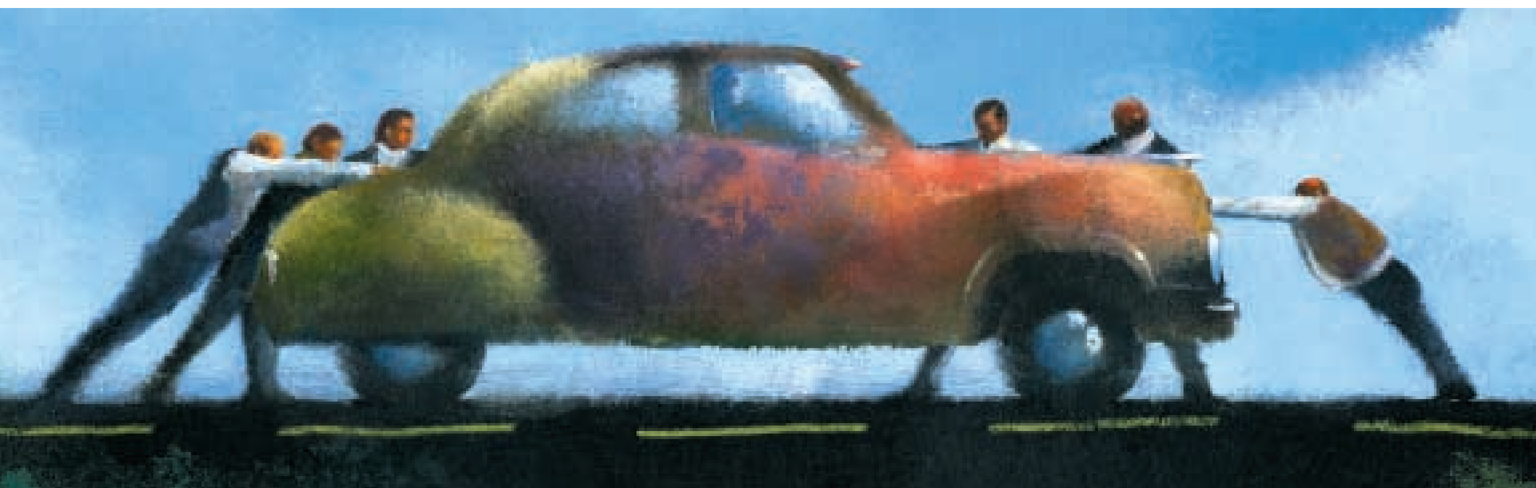
FOR THE 25 non-Asian countries in transition, more than ten years have passed since the fall of the Berlin Wall signaled the beginning of a dramatic journey from socialist ownership and central planning to private ownership and a market economy. Progress varies considerably from country to country. Some Central European countries and the Baltics are close to being predominantly market economies. They have experienced healthy and sustained economic revival and are well on the way to meeting the conditions for membership in the European Union (EU). In contrast, although many of the countries farther east and some in southeast Europe have implemented reforms and no longer have socialist economies, they are still struggling to develop their private sectors, complete the liberalization of prices, establish market institutions, rationalize government activity, and impose an effective rule of law.

True, virtually all of the countries in the second group have not only begun to work seriously on the tasks involved in the transition to a market economy but also largely succeeded with one of the most important and difficult: controlling budgets and monetary emission sufficiently to bring inflation rates down from four and five digits to single digits in many countries, with only a few countries registering inflation rates above 20 percent. Nevertheless, too many of these countries, having implemented partial reforms, are not simply moving more slowly than the advanced reformers but are stuck in a rut. One explanation is that the lagging economies of the Commonwealth of Independent States (CIS) had unfavorable starting conditions, including more years spent under a communist system, a greater distance from Western Europe and the incentive of EU accession that has spurred reforms in other post-socialist economies, the landlocked status of much of Central Asia and the Caucasus, overindustrialization in the western CIS, and civil conflicts in some countries. Although it is true that unfavorable initial conditions play a role, this role diminishes over time. Moreover, some of these countries enjoy advantages that those in Central Europe



lack: several enjoy a wealth of natural resources, and a few have a very high level of scientific and technical human capital, a by-product of the Soviet military-industrial complex.

In this article, we focus on an additional explanation—namely, that economic reform has been thwarted by rent-seeking vested interests who have the most to gain if reforms stall halfway between the central planning of the past and a well-functioning, open, and competitive market economy. This explanation may be complementary to the initial conditions theory; the stagnation of transition may be due to both poor initial conditions and vested interests. Or, it may be that adverse initial conditions allow vested interests to capture economic policymaking.

"The activities of powerful economic vested interests are undermining attempts to continue the reform process."

How rent seekers capture policy

At the outset of the transition, the Soviet elites known as the *nomenklatura* (party hierarchy, managers, bureaucrats) no doubt feared they would lose their privileged positions. And, indeed, in countries where market reforms began early and moved fast, quickly shrinking the government's role in the economy, the power and influence of socialist elites were curtailed, sometimes politically, or at least blunted by new competitive market disciplines. In countries where reforms did not move ahead briskly and steadily, new opportunities for personal profit making opened up. Among the new entrepreneurs who seized these opportunities were many members of the former elites, who were able to leverage old *nomenklatura* status and connections into lucrative operations. (The mechanisms are described in detail in Banaian (1999) for Ukraine, and Shleifer and Treisman (2000) for Russia.) Typical was the continued subsidization of energy and key raw materials in Moldova, Russia, Ukraine, Uzbekistan, and elsewhere, which created opportunities to obtain a government trade license to make large rents from buying primary products cheap and selling them at world prices, sometimes illegally on local black markets, sometimes legally for export. The populist call for credits to industry and agriculture in support of jobs and production resulted in high inflation and real interest rates that were often negative. Enterprises borrowing at such attractive rates (and sometimes not even paying back the highly depreciated principal) acquired funds that could be siphoned off through favorable contracts with new spin-off (but related) private enterprises, some of which would engage in the commodity-related rent seeking just described.

Two decades earlier, it had been shown that, in the developing countries, rent seeking could be more profitable than productive activities (Krueger, 1974). The same turned out to be true for the transition countries. It quickly became clear to enterprising individuals in partially reformed transition countries that they could reap much higher profits by obtaining privileges in a system marked by continuing government interventions than by setting up risky new ventures to restructure old, inefficient industries or starting up new companies. Membership in the old elite was not necessary but certainly helpful; it guaranteed early access to insider information and made it easier to pay off friends in the policymaking bodies with impunity. Corruption and side-payments were a natural outgrowth of this new rent-seeking system.

The impact of rent seeking on economic reforms can be examined further in the context of the four key components of the transition process: financial stabilization to overcome the damages of high inflation; privatization of state enterprises to increase their efficiency and responsiveness to market signals; liberalization of markets to allow open competition and ease of entry; and institutionalization of market-enhancing practices, such as the rule of law and the security of property rights.

In the early 1990s, the new vested interests took advantage of the populist atmosphere to obtain subsidies, tax breaks, and directed credits from the authorities, at the expense of macroeconomic stability. This changed in 1995, by which time the key groups in Russia and some other countries controlled large banks and therefore favored tight monetary policy because they were able to make large incomes from lending to the government at high interest rates, as described in Shleifer and Treisman (2000). Also, as recent owners of capital, they came to recognize that stable prices were better for the economy and that a bigger, thriving economy provided more opportunities for future profits. Privatization was also in their interest because their newly accumulated wealth plus the influence it bought enabled them to buy state assets on very favorable terms. Thus, ultimately, vested interests have supported both stabilization and privatization.

The other two categories of reforms are not as favorable to vested interests, who have therefore opposed them. Liberalizing markets to smooth the path for true competition and easy entry by new small entrepreneurs (and foreign investors) undermines the monopolistic position of some of these vested interests. Fully liberalizing prices reduces the rent opportunities that continued government intervention creates. Profits rather than competitive markets are what capitalists seek to maximize, and reducing monopolistic power reduces profits. A monopolistic concentration of assets quickly occurred in transition countries, enhancing the influence of the newly rich vested interests, which include a group of superrich oligarchs. The imposition of the transparent, evenhanded rule of law and the protection of property rights have also met with opposition, because these

reduce the economic value of the privileged position that (often nontransparent) vested interests have nurtured with bureaucrats and policymakers.

Thus, vested interests push for partial transition, an equilibrium (at least temporarily) frozen into an economy with private ownership but without a competitive market affording equal access to entrepreneurial opportunities. Reforms may continue in this partial transition, but only those that do not have a direct impact on the economic interests of vested interests can proceed easily. Such reforms include institution building by governments, such as the strengthening of the central bank (although not necessarily its banking-supervision functions) and the treasury, as well as broader public administration reforms aimed at streamlining the government and making it more efficient. But reforming the tax system and strengthening tax administration are often opposed by vested interests. They have found that many governments in the region are willing to grant tax exemptions and even tolerate tax evasion, especially if given financial inducements.

To sum up, the activities of powerful economic vested interests are undermining attempts to continue the reform process. One part of this strong opposition to completing reforms is the old party and managerial elite—ironically, not because they are the main losers, as predicted in 1990, but because they became, in fact, the winners of partial reform. More broadly, the heart of the opposition comprises groups that, having created dominant positions, have exploited their power to persuade governments and parliaments to prevent reforms that would threaten those positions.

How will vested interests be overcome?

Looking ahead, one can see ways to overcome the opposition of vested interests to genuine market-oriented economic reforms. Change could come either from within the vested interests or from outside.

The vested interests themselves might be willing to accept certain reforms, for two reasons. First, they might decide that their own long-run interests are best served by a society in which property rights are protected and the rule of law obtains, rather than one ruled by lawlessness, like much of the CIS today. Such a shift from predator to conserver has been seen in market economies over the centuries. For example, the robber barons of the United States in the late nineteenth century were not only coerced by trust-busting but themselves became increasingly interested in obeying laws that helped them protect their new wealth. Additionally, individuals who reach this stage sometimes wish to create a good name for themselves and leave their mark on history—for example, by setting up charitable foundations—and may also seek to improve their country's reputation abroad by supporting patriotic causes.

Second, vested interests may change their behavior for much narrower economic reasons. In the CIS, there are signs that business groups are beginning to realize that it is better to forgo some short-term gains (obtained by, for example, theft through barter transactions or extortion) to create better conditions for the economy and their own wealth to grow. This may be part of the reason for the decline in the share of barter in interindustry transactions in Russia and Ukraine in the last year or two. Because their early gains tend to be transitory (high inflation that benefits borrowers, insider-dominated privatization, raw materials underpricing), vested interests' natural tendency over time is to depend increasingly on the operating profits of their new investment and production activities. Thus, they eventually come to realize that owners of capital can make higher profits in a stronger economy.

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Change from the outside can come in a number of ways. First, a strong leader might emerge who is willing to take on the vested interests to advance economic reforms and provide better opportunities for competitors, domestic and foreign. An example of such a leader is Argentina's Carlos Menem, who, though head of the Peronists, was the first to try to end decades of economic stagnation resulting from Peronism's bad economic policies, which were dominated by vested interests. A less dramatic but still relevant example is Bulgaria's reformist government, elected in the winter of 1997. Before this, Bulgaria was considered the best example in transition countries outside the CIS of the capture of policy by strong vested interests. Rapid stabilization and other structural reforms appear to have succeeded not only in turning the economy around after a crisis in 1996 but also in forcing the vested interests to play by the rules.

Second, a growing middle class could use the political process to strengthen the rule of law gradually and undermine the special privileges of vested interests. The vested interests will, of course, try to prevent this from happening through their own financial control of the political process. But it could occur when the opposing forces are somewhat balanced and the vested interests do not have overwhelming power or when they realize that continued opposition to small entrepreneurs is ultimately against the national interest. More generally, a sizable middle class with political power could emerge before the vested interests have been able to mobilize their opposition to it. The best prospect is in the large underground economy of small entrepreneurs in Russia and Ukraine just waiting to stride onto a larger stage.

Third, pressure on vested interests can come from outside the country, particularly from foreign competitors. The position of vested interests is weaker in countries that encourage foreign direct investment, and if these interests opposed all foreign investment, they would hamper growth and lose their popularity. Other external pressure might come from the international financial institutions and bilateral donors using loan conditionality to push through key reforms even if vested interests resist. This may be an important factor in whether or not the transition process advances or remains mired in the intermediate stage. Of course, the international financial institutions have maximum effectiveness only when the authorities are fully committed to the program and welcome such strong conditionality.

Winners and losers

At the outset of the transition, most observers agreed that the necessary reforms would create winners and losers, and that the latter would surely work to oppose them. It was expected that losers would include not only workers in inefficient industries but, more important, the Soviet *nomenklatura* and bureaucracy. By the mid-1990s, this prediction turned out to be half right: many former members of the *nomenklatura* and bureaucracy have become major opponents to continuing market reforms, not because they were the losers, but, paradoxically, because they captured the process sufficiently to be the winners. A combination of old personal connections, lobbying influences, and opportunities for large profits through government-afforded privileges enabled some individuals—new businessmen as well as the old ruling class—to become quite wealthy and powerful and to form a new capitalist elite.

It is difficult to predict whether some or all of the conditions discussed above will strengthen in the coming years, eroding the power or desire of vested interests to block economic reform. However, those both inside and outside pushing for more economic reform for the good of these countries' populations should work toward creating the conditions in which such changes can occur. At a minimum, all efforts to build up, even very slowly, the knowledge of market operations (for example, studies in economics and business) and the formal institutions of market economies (such as stock exchanges and regulatory bodies, and commercial and contract laws and related judiciary mechanisms) are needed to prepare for the time when the influence of vested interests can be overcome and an open, competitive economy supported by effective property rights can be put firmly in place. But, in addition, all politically favorable opportunities to battle these interests and to move toward fuller liberalization of markets, greater competition, and the removal of privileges like tax exemptions or rent-creating government regulations that favor vested interests should be grasped. F&D

Suggestions for further reading:

King Banaian, 1999, The Ukrainian Economy Since Independence (Northampton, Massachusetts: Edward Elgar).

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Andrei Shleifer and Daniel Treisman, 2000, Without a Map: Political Tactics and Economic Reform in Russia (Cambridge, Massachusetts: MIT Press).

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