

Lecture Note: Government Collapse

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1. Introduction

An important issue in transition is the collapse of government. In many TE's, the government is too weak where it needs to be strong – e.g., contract enforcement – and too strong where it needs to be weak (or small), such as regulating enterprises. We certainly see differences in predation and government behavior across TE's. The problem has been referred to as the "grabbing hand" (as opposed to the invisible hand) by Shleifer. Government predation reduces the returns to restructuring and economic activity.

For example, Kaufmann, McMillan and Woodruff using surveys in manufacturing, found that in Russia and Ukraine about 90% of managers pay "protection," while the corresponding number in Poland is 8% (15% in Slovakia and 1% in Romania). Similar results in the following table.

Surprisingly, the empirical evidence indicates that financial constraints are not critical either in CEE or in NIS [7]. In a survey of small manufacturing firms in Poland, Slovakia, Romania, Russia and Ukraine, Johnson et al. [4] show that access to credit does not affect investment. Frye [1] studies shops in Moscow and Warsaw and also corroborates that shopkeepers do not see finance as major problem. The niches for small business are so huge that the businesses that do get through are able to earn enough profit to support business growth.

There is a clear dichotomy between CEE and NIS in terms of competition and government predation. In the CEE, competition has already become an important constraint. Unlike their counterparts in Moscow, shopkeepers in Poland name competition as their major concern [2]. In the NIS, the major problem is predation. Small businesses are taxed and regulated at exorbitant rates. In order to survive they hide some or all of their incomes and become part of the

Country	Romania (4 cities)	Poland (Warsaw)	Russia (Moscow)
Used courts in last two years	0.20	0.14	0.19
Needed to use courts but did not	0.15	0.10	0.45
Can use courts against government	0.51	0.41	0.50
Can use courts against business partner	0.67	0.45	0.65
Contacted by racket in the last 6 months	0.00	0.08	0.39
Does one need a 'roof' ('umbrella') to operate?	0.01	0.06	0.76

Figure 1.1: Government vs. private of contract enforcement for small businesses. Source: [5] and [2]. 'Roof' and 'umbrella' are euphemisms for mafia protection in Russia and Poland, correspondingly.

unofficial economy. Once in the unofficial economy, the firm is prevented from seeking contract enforcement and protection from the state. These services are provided by members of organized crime who extract most of the monopoly rents in exchange.¹ In the CEE (inclusive of Romania and Bulgaria) small firms report that neither government nor private rackets are an important problem. In the NIS firms do not grow enough to fill out all the niches; hence competition is much less intense and monopoly rents correspondingly greater. These rents are an attraction to predators, whether public or private. Hence, there is a relationship between the extent of competition and the degree of predation.

1.1. Blanchard-Shleifer

Why do some governments predate more than others? Why, for example, has the private sector developed more in China than Russia? BS study this question. They put forward two hypotheses for predation in Russia.

- capture by older firms. Local governments work to generate transfers to older firms and to protect them from new competitors

¹Corrupt bureaucrats also play a role.

- competition for rents by local officials. unintended effect of administrative disorganization. Too many agencies trying to extract rents from new private firms

But why weaker in China? BS point to several explanations.

1. initial rent holders weaker in China – related to level of development
2. strength of central government in China – no collapse of party.

BS focus on the consequences of the latter explanation.

1.1.1. Simple Model

Government has two levels: central and local. Each local Gov. has a simple choice:

- foster growth, by limiting transfers of resources to state and former state firms and allowing new private firms to enter and grow, or
- kill growth, by transferring resources to old firms and/or preventing new firms from being created.

Why would the government do the latter? Under the capture view it is straightforward. Under the competition for rent view the government might be simply unable to prevent bribes and corruption. Both have the same implication for growth.

Let y be the additional output under growth, and normalize this so it also stands for the additional amount of revenue available to the central and local governments under growth. Let b be the private benefits to the local Gov. of killing growth.²

Now turn to central government. It is assumed to prefer growth. It has a carrot and a stick:

²Under the capture view this could be transfers back from existing firms – investing in relational capital. Under the rents interpretation it could be the cost to local officials of trying to stop bribe-taking.

- Revenue Sharing. Central gov. can choose the extent of revenue sharing. Let a be the share of revenues from additional growth going to the local government. If it chooses to foster growth it gets ay . Normalize so this is also how much it values growth. We should note that it is *ex post* a that is crucial.
- Political centralization. This is the stick. Central gov. controls whether the local gov. can stay in power. Let p_x be the probability that the local gov. stays in power if it kills growth, and p_y is the probability it stays in power if it fosters growth. Let $p = \frac{p_y}{p_x}$. The value of p will clearly depend on how local officials are chosen. In China they can choose p freely. In Russia, where there are now elections, it depends on how effective the central government is at affecting elections.
 - it would be nice if p were greater than one, but if the center has little control over outcomes, and if capture is important, then it may be less than one.

Under these assumptions the local gov. chooses growth if

$$p_y a y > p_x b$$

or

$$p a y > b. \tag{1.1}$$

Expression (1.1) says that the local gov. is more likely to choose growth the stronger the stick (high p), the larger the carrot (higher a), the larger the growth potential (y), and the smaller the benefits of capture or the lower the costs of reducing rents (b).

Obviously if y is small – poor growth prospects – then it really doesn't matter much about carrots or sticks.

The empirical evidence seems to indicate that a is pretty low in Russia. A bit hard to decipher because there are actually three regions and most of the work looked at the bottom two. But there appears to be a lot of fiscal transfers. Few taxpaying regions and many recipients of subsidies. Zhuravskaya finds a to be as low 0.1. In China, on the other hand, a appears to be quite high – near to 0.8.

Why the difference? BS focus on the fiscal problems of the center, which renegotiates its stake and cannot commit. What they ignore is an important structural difference. In China industry is not geographically specialized, in Russia

it is. So for insurance reasons, alone, the optimal contract would have more fiscal federalism in Russia, hence lower \mathbf{a} .

Notice that \mathbf{p} also differs significantly between China and Russia. In China the Party still rules, so \mathbf{p} is very high, could be enormous. In Russia governors are elected, and the center cannot always get their way. So \mathbf{p} is much lower, perhaps less than unity.

This suggests that differences in \mathbf{p} could offset large improvements in \mathbf{a} in the case of Russia. With high enough \mathbf{p} a high \mathbf{a} may not even be necessary.

1.1.2. Discussion

The model suggests that to the extent federalism has been important in promoting growth in China, such federalism relied crucially on the power of the Party. Greater democracy could mean much lower \mathbf{p} . Then we would see how important are the differences in \mathbf{a} .

The model also suggests that in Russia the primary problem may be political decentralization. Improvements in \mathbf{a} may have little effect in this environment. In other words, the economic benefits of federalism depend on some degree of centralization. Presumably Putin understands this.

1.2. Assessment

What BS do not answer is why local governments are more likely to be anti-growth than the central gov.. They attempt to, arguing that larger units are less likely to be captured and that big oligarchs may be less anti-growth than local ones. But this is not all that satisfying.

It seems to me that one reason why regions are anti-growth is that they preside over loser regions. If they have a large share of dinosaurs, then policies that will be conducive to growth may also be conducive to growth elsewhere. The key point is that restructuring in Russia has a serious regional aspect to it, the governors realize this, and so they act accordingly. In this regard the comments of Viktor Tolokonskiy, Governor of Novosibirsk Oblast (August 2000) are instructive:

“Under conditions of total openness of the economy... , we here in Siberia should not expect any serious investment activity at all. Our costs of production are too high, residential housing and office manufacturing facilities are too expensive, and our transport costs and wages are higher than in southeastern Asia.”

2. The Geopolitical Factor

Roland [6, 338], among others, has suggested that geopolitical factors may have played a crucial role in transition differences.³ Transition offers CEE economies an historic opportunity to join the west. This is an opportunity that it would be politically unwise to miss. Hence, greater sacrifice and reform may be possible in these economies. Likewise, the promise of EU accession may present a penalty for policy reversal that is not present in the CIS countries. Roland has also pointed out that a "transition tournament" developed where the Visegrad countries competed to be first in line for accession. This competition also focused attention on reform and prevented backsliding.

In CEE's one might argue that the promise of EU accession may be an important factor in restraining the predatory impulses of officials in CEE's; the promise of accession may operate as a commitment device to provide regional and central governments with the right incentives. In CEE's, politicians know that they will have to cancel the most inefficient policies in a few years, while in NIS, there is no such clear endgame.

It can even be argued that EU accession may be an important enough factor to prevent government collapse. The idea is relatively straightforward. It is assumed that agents choose to be predators or producers. This decision is a coordination problem. If too many choose to be predators it does not pay for me to be a producer. But if most choose production, then it is easier for the government to clamp down on the predators. The question is how to coordinate on the good equilibrium. One way may be to borrow from abroad to purchase good enforcement of contracts. By breaking the budget link between taxes and enforcement it may be possible to reach the good equilibrium. But this may not work because once the debt must be paid back the government will once again have to tax and the good equilibrium breaks down.

Now suppose that the country has the chance to join the EU in period two. Then this may provide an alternative way to coordinate on the good equilibrium. If the prospect of accession offers higher returns to production in the future, and if predation today jeopardizes this, then the probability of accession may lead to

³The role of potential EU accession is recognized in by Fischer and Sahay in their discussion of differences in transition performance across countries. "For many countries, the prospect of joining the European Union has been a powerful spur to reform. The absence of that prospect for the OFSU countries (the former Soviet Union minus the Baltics) except perhaps eventually Ukraine must be among the factors retarding reform." (Fischer and Sahay, 2000: 22).

the good equilibrium. Of course, for this to work the promise of accession must be credible.

References

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