



Individual Advanced Research Opportunities Program

Research Report

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New Democratic Institutions and Corruption in Post-Communist Countries

Two stylized facts characterize government support of business activity in the postcommunist world: 1) new and small firms generally receive less support from government officials (as evidenced by the fact that they are obliged to pay more in bribes, are less likely to have contracts enforced, etc.) than old and large firms, and 2) the environment for business is generally worse in the former Soviet Union than it is in Eastern Europe. My research provides a partial explanation for these two phenomena.

My research began in Moscow, where I became intrigued by what seemed an anomalous success: despite the active participation of the municipal government in the local economy (often through direct ownership in local businesses), which many economists would expect to have negative consequences, the Moscow economy was more dynamic than any other in Russia. In explaining this anomaly, there are two general possibilities: 1) the economy performs better *because of* Moscow's unique institutions, or 2) the economy performs better *despite* Moscow's unique institutions. My attention initially focused on the former possibility. The Chinese experience suggests that municipal ownership of productive enterprises, while generally unhelpful, can be useful in an environment where government officials are predisposed to hinder private economic activity. By providing governments with a profit motive, local government ownership can encourage officials to provide support to at least government-owned businesses, if no others.

While I am as yet unsure of the importance of this factor to the success of the Moscow economy, this initial foray ultimately led me to a more fundamental insight: it is not only ownership, but the ability of local governments to extract a share of the profits of private enterprises in general, that is important in determining the allocation of support of business activity. Thus, for example, local governments may have disproportionate incentives to provide support for business activity that is easier to tax. In the postcommunist world, this means in part large businesses, since small businesses tend to find it especially easy to avoid paying taxes, as well as firms in sectors such as manufacturing which deal less in cash. Thus, my dissertation has come to focus on the *taxability* of economic activity, i.e. the ease with which the state may extract profits from economic agents, as a key determinant of support for business activity in postcommunist states.

Ultimately, this basic insight led to two related research projects. First, I used the tools of formal modeling (i.e. economic modeling) to identify under what conditions differences in taxability would lead to differences in government support. Second, I tested the predictions of these models using data from a survey of 4000 firms in 23 postcommunist countries carried out in 1999 by the World Bank and the European Bank for Reconstruction and Development (EBRD). Throughout, I let my research be directed by conversations I had with entrepreneurs in Moscow and elsewhere in Russia.

Two basic ideas emerged from my project to formally model the relationship between a government which cares about tax revenues and economic agents who differ in their taxability. First, when factors of production (labor and capital) are mobile across sectors, then differences in taxability will be exaggerated: for example, governments will support large enterprises because of their taxability, which will encourage labor and capital to relocate to large enterprises, which in turn will further increase the incentive for the government to support those enterprises. Thus, for example, differences in taxability may have contributed to the prevailing situation in much of the former Soviet Union, where both factors of production and government support are heavily concentrated in old, large enterprises. Second, when governments are motivated to increase tax revenues for electoral reasons, i.e. because taxes pay for redistributive transfers and public goods which are valued by voters, then differences in taxability will have a greater impact on the allocation of government support if a government's overall tax capacity is low. Consequently, politicians in countries that have been able to maintain a relatively high level of tax capacity (such as the Czech Republic and Poland) have fewer incentives to support highly taxable sectors.

These other predictions are borne out in the empirical work mentioned above. More generally, statistical analysis strongly supports the basic insight that governments in postcommunist countries will have less incentive to support business activity when they expect little in the way of taxes or retained profits from those businesses. Firms which are especially hard to tax – small firms, firms in personal service or transportation sectors, firms in the former Soviet Union rather than Eastern Europe – pay more in bribes, are less likely to have their contracts and property rights enforced, spend more

time with government officials, and are less likely to say that local governments are helpful.

While policy recommendation is a dangerous business, there is perhaps one general recommendation that emerges from this research project which is in line with preexisting advice from multilateral organizations such as the World Bank and IMF. Postcommunist countries should be encouraged to developed broad-based tax regimes, rather than relying too heavily on taxes from relatively easy to tax sectors. Otherwise politicians will have too little reason to support the sort of businesses (new and small enterprises, firms in service sectors, etc.) which need to be developed.