

# Economics of Russian Crime

by Yuri Maltsev

## Introduction

The issue of crime is of the utmost importance for Russia and other formerly Soviet republics undergoing transition from a centrally administered economy to a market economy. Today the mafia is a prominent feature of a Russia in transition.<sup>1</sup> The shocking 1994 murders of Duma deputies Andrei Aizderdsis and Valentin Martemyanov attracted public attention to the inability of the State to cope with the crime. Gangland slayings, daylight robberies, hostage-taking, rape, and bribery of officials have all become part of life in the new Russia.

Calling Russia a crime “superpower,” President Yeltsin has declared that he will make law and order his top priority. Leaders of opposition from “democrat” Grigory Yavlinsky to ultranationalist Vladimir Zhirinovskiy are calling for harsher measures and more resources for law enforcement. While many pundits point to the rise in crime as evidence of the social cost wrought by the transition to the market, it is more appropriate to focus our attention on the institutional incentives that resulted in this rise of criminal activity.

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With the collapse of the USSR in 1991 there was little, if any, change in the organization of the criminal justice system in Russia.<sup>2</sup> The Russian criminal code is so oppressive and pervasive that “one must virtually retire to hermitage in order to avoid committing a crime.”<sup>3</sup> Russia's prisons, probably the worst in the world, are still filled with over 100,000 entrepreneurs, most of whom were convicted for commercial and business practices absolutely legal in civilized countries. Private production and exchange—the most natural of human activities—are still criminalized through a confiscatory tax system and monstrous regulatory mechanism.

If businesses expect future profits to be taxed away, they usually choose not to become profitable in the legal economy. In Russia today too few people understand that property rights cannot exist without stability and legality in taxation. Onerous tax laws and pervasive regulation contribute to over 600,000 convictions per year.<sup>4</sup>

In a speech last year, Jeffrey Sachs, a Harvard economist and a former adviser to Yeltsin's government, dismissed the “excess focus” on the supposed corruption in Russia, arguing that “many of those who are called mafia are simply traders.”<sup>5</sup> Economic crime in Russia is the result of the absence of legal remedy and arbitrary bureaucratic power.

Economic crime has been a way of life and survival for a large segment of the Soviet population. With the collapse of the oppressive machinery of the State (and the failure

of a liberal regime of property and contract law to emerge) economic crime remains a rational response to the incentives.

A recent survey of people in Tatarstan who regularly travel abroad to purchase goods—a group of people generically called “shuttles”—found that half of them have to pay off local officials and more than 40 percent are controlled by criminal gangs. Most of those engaged in this activity are highly educated (82 percent have at least a secondary degree) and many are women (80 percent). Four out of five of those involved said they engaged in such purchases to feed their families. By criminalizing these activities the Russian government is opening the door for the organized crime.

The suppression of economic freedom and individual initiative has led to widespread apathy and a complete lack of individual responsibility, as well as emergence of black market entrepreneurship. Decisions concerning economy were of pure political character. Assumed orientation of these decisions and corresponding propaganda on “the Communist civilization of tomorrow,” “world victory of socialism,” “complete satisfaction of societal needs,” “scientific and technological revolution,” and other abstract goals undermined entrepreneurship and initiative, made people helpless in dealing with the Leviathan state.

The widespread frustration with the failure of perestroika and so-called “shock therapy” reforms of Yeltsin’s government have led to the situation when every new announcement of impending reform causes perverse public responses, every new law passed, ostensibly to increase freedom, only increases opportunities for fines and bribes. All economic and fiscal legislation in this period has been absolutely inconsistent with legality. Every law that has promised stability in taxation and established rules of economic conduct has been overtly revoked to the preservation of the willful government expropriations. As popular Russian journalist Victor Kopin assesses the present stage of the “Capitalist Revolution” in Russia: “The White Guards’ attack on socialism failed. We have gotten the quasi-democratic

society with quasi-market, quasi-legality, quasi-morality. The predominant conclusion out of it is that freedom leads to the devastation of spirituality, crime, pauperization of masses, and emergence of a class of fat cats.”<sup>6</sup> But this reality of Russian life is not new. Rather, it is a continuation of the “bureaucratization” of life, and the corruption endemic of such a system, that characterized Soviet rule.

## Corruption

Corruption is usually defined “as behavior of public officials which deviates from accepted norms in order to serve private ends.” It was assumed by the socialist ideology that the Communist Party officials being altruistic servants of the “public good” were acting selflessly with the right answers provided by the “scientific approach” of Marxism-Leninism. They could and would in the long run solve all social and economic problems inherited by the socialist society from capitalism. The reality was different: party and government functionaries have come to believe that state property belongs to them. The belief that factories and plants belonged to their managers was enforced after the collapse of the USSR and by the proclaimed goal of privatization and establishment of the market economy.

Unlike most East European countries where Communism was viewed as an alien ideology imposed by force by the occupying power and local Communist officials as collaborators with this power, in Russia former Communists are occupying over 60 percent of senior positions in local governments and close to 90 percent in the central government. The number of these bureaucrats in 1994 in Russia alone was around 10 million. Given that such people “plan” and manage state property and economic life in general in their own interest, it is not surprising that bureaucrats became the most powerful economic elite in Russia.

There are different types of bureaucratic corruption:

1. Extortion, or the “black market bureaucracy,” which refers primarily to pre-

miums paid to get the bureaucracy to do, or to do promptly, what it is supposed to do anyway is ubiquitous in Russia.

2. Nepotism—being another typical pattern of bureaucratic behavior in Russia—is the appointment of relatives, friends, or academic colleagues whom you trust in order to assure control over subordinate personnel. Nepotism is usually widespread in the public sector everywhere due to the absence of the profit motive. In Russia there are “family dynasties” of plant managers, government officials, and other types of administrators.

3. Nepotism and bureaucratic extortion start the hard core of corruption which consists of “deliberate theft, bribery, and tax evasion to divert public resources to private benefit, or to avoid paying taxes legally owed in the first place. It also includes the use of influence to skew the allocation of resources to programs, cities, or projects in violation of regime goals as represented in official plans.”<sup>7</sup>

A new class of Russian entrepreneur is on its way to becoming a private bureaucracy. The source of bureaucratization of private enterprise in Russia is the same as everywhere else—the destruction of the profit motive by government regulation and taxation.

This elite of government apparatchiks and new “entrepreneurs” want to maintain their economic and political power. Nobel laureate James Buchanan has observed that “rent seeking”—that is, competition for government largess and protected profits—emerges as a significant social phenomenon as institutions move away from ordered markets toward the near chaos of direct political allocation.<sup>8</sup> According to a report, presented by expert Vladimir Ovchinsky, in 1993 law enforcement agencies investigated 15,500 cases of corruption and abuse of public office. Among corrupt personnel, about 43 percent were federal and regional officials; 25 percent law enforcement officers, including members of the Federal Counterintelligence Service; 4 percent officials from presidential and federal oversight bodies; and 2 percent members of federal and

regional legislatures. (In contrast to the practice in Western democracies, Russian deputies are immune to prosecution for criminal offenses.)<sup>9</sup> “Corruption,” exclaimed Boris Yeltsin last year, “is devouring the state from top to bottom.”<sup>10</sup>

Corruption is widespread in the law enforcement agencies. Interior Minister Viktor Erin told the State Duma that 500 law enforcement officers had been arrested in the first nine months of 1994 on corruption charges.<sup>11</sup> Major-General Igor Shilov, Deputy Chief of Criminal Investigation Directorate of the Ministry for Interior of Russia was arrested together with his son—a cadet of the Russian Police Academy, and seven other senior officials of the Ministry. They are accused of corruption, hoarding of arms, and links with the mafia.<sup>12</sup>

## Inhibiting Foreign Investment

Widespread corruption resulting from an overregulated economy is often cited as a major obstacle for Western investors in Russia.<sup>13</sup> Foreign investors complain that bribes are being sought and taken on all levels of Russian bureaucracy. Without bribes, nothing can be done in banking, construction, transportation, and other vital businesses. In 1992 there were 7,820 cases of crimes with foreign visitors as victims.<sup>14</sup> The crime situation is one of the most discouraging aspects of Russian reality perceived by foreign investors. As Annelise Anderson points out: “A full-fledged mafia can . . . have serious consequences for the economic growth of the legitimate economy. The mafia may create monopolies in local enterprises, control entry, and maximize revenue by extracting monopoly profits as protection payments. New investment may be discouraged and old investment driven out. Risk-averse investors are likely to seek localities less arbitrary and dangerous.”<sup>15</sup>

Russia today has over 240,000 arbitrary trade laws and regulations that are special-interest transfers through the corruption of central and local governments. It has 111 different federal and local taxes with the tax

codes that no one can understand except those bureaucrats who drafted them. The Russian tax police can violate every right "guaranteed" by the new Russian Constitution to collect more revenue. So, it is no surprise that *Euromoney* has rated Russia 138th in favorability for foreign investment.<sup>16</sup> Widespread economic cheating involves such things as over-reporting and double counting.

Economic decisions of the Russian government are frequently based on deliberately falsified reports of state enterprises, which are inclined to report economic indices in a way which is beneficial to them. Very often cheating is done by the Goskomstat itself as it was recently proved by the Russian economist V. Yuryev, who used as an example the Goskomstat report on economic padding and stealing.<sup>17</sup> Moreover, it has been argued that the falsification of production figures has intensified since perestroika and the subsequent collapse of socialism—largely because of the poor discipline and tax-evasion motives at the enterprise level.

Russian government economic statistics paint a bleak picture of the further decay of the Russian economy in 1994: a 16 percent decline of the GDP, a budget deficit of 9.8 percent of GDP, inflation of 209 percent, an interest rate of 242 percent, and meager average wages of \$88 per month.<sup>18</sup> The evolving crisis in the Russian economy can be explained by the fact that, despite the surfeit of laws and decrees, the Yeltsin government has made little or no progress in establishing economic legality, and no effective market mechanism has replaced the one based on the political allocation of resources.

The recently adopted "radical economic reforms" of Chernomyrdin's cabinet seek to create favorable conditions for the bureaucratic and technocratic elite to become the new owners of the state property. "Spontaneous privatization" takes the most ugly, uncivilized forms. Moscow *Kuryer* reported that the top officials of the former Council of Ministers of the USSR "privatized" their state-owned dachas (out-of-town resi-

dences) for less than 10 percent of their nominal and 3 percent of their market value.<sup>19</sup> V. Davituliani, President Yeltsin's former representative in the Tambov oblast in Russia's European heartland, painted a gloomy picture of "reforms" in Tambov. The local government, he wrote, "consists 99.9 percent of former party and factory nomenklatura, who continue to take bribes and build houses for themselves just as they did before."<sup>20</sup>

Obviously, Yeltsin's economic reforms started from the wrong end. The new "free market" sales tax amounts to 28 percent. The absurdity of the "new economic thinking" in Moscow led to the new Export Tax which levies heavy duties on anything (not much!) being exported from Russia. This tax served as a cold shower for the Western businesses who are closing their offices in Russia. It is also explicitly serving the corrupt foreign trade officials in Moscow. Bureaucratic networks are so deeply rooted that the *ancien régime* is still largely in place, protecting a status quo that has been bolstered in large part by geopolitical interests of the Western bureaucratic establishment. The current Economic Minister of Russia Yevgeni Yasin admitted that "the influence of politics on economy have reached now its greatest possible dimension."<sup>21</sup>

Yeltsin's government has chosen the least daring, least radical of the reform options available. Bureaucratic networks are so deeply rooted that the old order is still largely in place. The new political leaders of Russia may alter policy priorities but the widespread organized crime and bureaucratic corruption will inevitably retard the effectiveness and duration of their policies. The economic consequence of this status quo is to further the fundamental problem of a fully bureaucratized society.

## What Should Be Done

A comprehensive program to combat crime in Russia should include legal reform, the privatization of industrial and agricultural property, provisions of free trade in shares at newly created stock exchanges;

denationalization of land; creation of labor markets through the elimination of existing restrictions on the freedom of labor to contract; immediate demunicipalization of housing; drastic cuts in military and other government spending; monetary reform aimed at achieving the convertibility of the currency in international money markets; and liberalization of foreign trade.

"One of the most basic insights of political economy is the need for rules to govern economic activity,"<sup>22</sup> states Peter J. Boettke. A stable market economy cannot function without a legal structure that is consistent with its underlying institutions of private property and freedom of contract. F.A. Hayek wrote 50 years ago that "It is the Rule of Law, in the sense of the rule of formal law, the absence of legal privileges of particular people designated by authority, which safeguards that equality before the law which is the opposite of arbitrary government."<sup>23</sup> Any reform of the Russian economy must be undertaken in concert with the institutionalization of the traditional understanding of the rule of law where the legal code is primarily directed toward defending person and property against invasion, either by the state or private parties.

The rule of law is central to any political and economic reform in Russia and the other republics. Governmental decisions must be rooted in the consensus of the governed, acting through structures designed to prevent individual oppression or political tyranny, and procedures are subject to appraisal by an independent judiciary rendering judgments based on law. It stands in contrast to decisions based on arbitrary fiat of power, political rent-seeking or personal gain. But most meaningfully the rule of law encompass fundamental conditions for creating a modern constitutional state:

- protection of the property rights and provision for civil legal remedy and contract enforcement;
- separation of powers and checks and balances;
- representative democracy and constitutional limits on governmental action against the individual and minorities;

- federalism; and
- review by an independent judiciary for constitutional enforcement.

Thus, government maintains a framework of security and order within which liberty can be secured. Individual rights of person and property are treated as normatively prior to government, as standards that take precedence. Governments are instituted among people so as to secure and protect those rights. Yeltsin's government is far from having embarked on meaningful legal reforms in this direction. Legal protection of private property, including the ability to assign, sell, and alienate, is still prohibited unless the law allows exceptions. Perestroika did not change this. The August Revolution of 1991 declared the necessity of the rule of law but failed to deliver any meaningful measures in this direction.

## The Need for Radical Reform

The transition to a legal state requires a radical overhauling of the present system. These reforms require a full consensus of the population: "Constitutional change becomes meaningless, however, unless it is accomplished by constitutionalist procedure, which, in the practical sense, means generalized assent on the part of most if not all citizens."<sup>24</sup> Reform also requires some means for individuals to redress grievances against government officials; some means for protecting the rights of minorities against the will of the majority; some means for separating the powers of government offices; and some means of checks and balances to prevent one unit of the government from encroaching on the functions of another. Perhaps most importantly, the rule of law requires some means for the peaceful overthrow of unacceptable rulers. Without these measures, all legal reforms, and economic reforms for that matter, are not likely to succeed in the long run.

Due to the urgent need to create a stable, orderly society based on an effective market, it is important to enact reforms as soon as possible. Gradualism should be eschewed in favor of a radical and immediate overhaul.



The Soviet situation teaches that "without effectively signaling and establishing a binding and credible commitment to liberalization, the behavior of the government simply destabilizes the situation."<sup>25</sup> One of the least desirable unintended consequences of this destabilization is a rapid and abrupt rise in economic crime in Russia. To prevent its further spread in Russia and beyond, the required legal and economic reforms should be implemented as quickly as possible. □

1. See Annelise Anderson, "The Red Mafia: A Legacy of Communism," in *Economic Transition in Eastern Europe and Russia: Realities of Reform*, ed. by Edward P. Lazear (Stanford, Calif.: Hoover Institution Press), 1995, p. 340.

2. "Criminal justice" is usually defined as a combination of "all the means used to enforce those standards of conduct which are deemed necessary to protect individuals and to maintain general community well-being." In the Soviet Union the major goal of the criminal justice system was protection of the socialist state and public property. Individuals and their property were considered as residual claimants for the protection. Penalties for crimes against the state and its property were more severe than that against individuals and their property.

3. David M. Gordon, "Capitalism, Class, and Crime in America," in *The Economics of Crime*, ed. by Ralph Andreano and John J. Siegfried (New York: John Wiley and Sons, 1980), p. 94.

4. *Moscow News*, No. 34, August 26–September 1, 1994, p. 14. It is virtually impossible to make any quantitative comparisons of the dynamics of criminal activity; reliable statistics of crime are not existent. Propaganda officers would doctor criminal statistics without any relevance to reality. "We do not fake it—we make it," a senior statistician of the MVD (Ministry of Interior) in Moscow told me. Statistics were and

still are a weapon in ideological war with the West, as well as in political battles for power inside the country.

5. *Newsweek*, November 14, 1994, p. 40.

6. Victor Kopin, "Totalitarnaya Demokratiya," *Stolitsa*, No. 37, 1992, p. 1.

7. Robert T. Daland, *Exploring Brazilian Bureaucracy Performance and Pathology* (Washington, D.C.: University Press of America, 1981), p. 235.

8. "Rent Seeking and Profit Seeking," in *Toward a Theory of the Rent-Seeking Society*, ed., James Buchanan, Robert D. Tollison, and Gordon Tullock (College Station, Texas: Texas A&M University Press, 1980), pp. 3–15.

9. RFE/RI, *Daily Report*, No. 218, 17 November 1994.

10. Claire Sterling, "Redfellas," *New Republic*, April 11, 1994, p. 19.

11. RFE/RI, *Daily Report*, No. 218, 17 November 1994.

12. "Razvitie skandala v MVD Rossii," *Nezavisimaya Gazeta*, May 11, 1994, p. 1.

13. See, for example, "Pray for the Russians, But Don't Invest There," *Milwaukee Sentinel*, October 31, 1994, p. B1.

14. *Militsiya*, No. 4, 1993, p. 20.

15. Annelise Anderson, *op. cit.*, p. 343.

16. *Nezavisunata Gazeta*, April 9, 1994, p. 4.

17. V. Yuriev, "Yesli verit Goskomstatu . . .," *Ekonomika i zhizn*, No. 28, July 1990, p. 12.

18. "Estonia: In a bear's paw," *The Economist*, November 19, 1994.

19. *Kuryer* (Moscow), June 1991.

20. *Crossroads: A Monitor of Post-Soviet Reform*, Vol. III, 1994, p. 3.

21. *Birzhevyye Vedomosti*, No. 1, January 1, 1992, p. 1.

22. Peter J. Boettke, "Credibility, Commitment, and Soviet Economic Reform," in *Economic Transition in Eastern Europe and Russia*, p. 268.

23. F. A. Hayek, *The Road to Serfdom*, Fiftieth Anniversary Edition (Chicago: The University of Chicago Press, 1994), p. 87.

24. James M. Buchanan, "Constitutional Imperatives for the 1990s: The Legal Order for a Free and Productive Economy," in *Thinking About America in the 1990s*, ed. by Annelise Anderson and Dennis L. Bark (Stanford, Calif.: Hoover Institution Press, 1988), p. 257.

25. Boettke, *op. cit.*, p. 269.

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# In Praise of Train Wrecks

by Doug Bandow

While most Americans were going about their lives, denizens of the nation's capital were scrambling to avert a "train wreck"—a deadlock over the budget that would force a government shutdown. In fact, members of the administration and Congress alike couldn't seem to think of anything worse than closing the federal bureaucracy.

One of the reigning principles in Washington for the past half century has been that government must play a pervasive role in managing our complex society. Of course, there have been disagreements on marginal questions—should spending on a particular program rise two or ten percent?—which have regularly generated histrionics on Capitol Hill. But disputes about the basic role of the state have been rare. Despite mass public dissatisfaction in recent years, presidents and legislators of both parties have kept alive hundreds of federal zombies, agencies and programs that have long outlived their purposes, assuming they ever did fulfill a legitimate need. Even some supposed conservative critics of Washington long accepted the status quo with barely a whimper of protest, choosing instead to help raise taxes to fund an endless soup-line for Washington's well-heeled interests. In recent years proposals for old-style pork barrel programs have been advanced in the name of "investments," like an expensive public employment program under the guise of "national service."

The federal government currently con-

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sumes \$1.6 trillion worth of national wealth, which is far too much. Yet every major proposed balanced budget plan will significantly increase that number. After decades worth of similar initiatives, it should be obvious that budget "reform"—small, incremental changes and slight cuts in growth rates of federal outlays—is no answer.

Rather, policymakers need to end programs, lots of them. And the only way to do that is to decide that some functions do not belong with the government. The best way to enforce serious cuts, in the face of continued resistance by important members of both parties, would be to welcome a "train wreck." Defenders of the status quo would then face a choice: either accept the end of at least a few programs, or shut down the government, killing every federal agency.

Of course, members of the Washington establishment quail at the thought of defunding Uncle Sam. Whatever would helpless citizens do? Typical is the American Federation of Government Employees (AFGE), which warns against "attempts to slash important government programs" that "threaten to diminish the scope of services the American public demands and expects." AFGE President John Sturdivant cites the potential horrors: "The protection of the elderly and the environment, the disabled and downtrodden, the safety of our food, products, transportation and workers and countless other responsibilities of the federal government would be severely disrupted under proposals to eliminate jobs and programs." His words echo along the Potomac.

There's no doubt all of these goals are