

# PATH-DEPENDENCE, PUBLIC CHOICE, AND TRANSITION IN RUSSIA: A BARGAINING APPROACH

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## INTRODUCTION

The transition process from communism in Eastern Europe is probably the most important economic challenge in the last twenty years. Some five years have elapsed since the political events that started this process, and in a limited number of countries (the Czech Republic, Slovenia, and the Baltic Republics) transition seems to be heading towards success; in others the prospects remain uncertain (as in Poland) or worrisome (as in Russia). Indeed, as has been observed about the Russian situation, the plausible possible futures for Russia "range from an enticing vision of society à la Milton Friedman to one more in the style of Stalin . . . . There is no end to incongruous data about the main remnant of what used to be the fatherland of socialism."<sup>1</sup>

A broad spectrum of transition attempts and results has been documented;<sup>2</sup> however, economists have yet to explain convincingly these differences. For instance, according to the neoclassical view, transition towards a market economy comes to a standstill because of the reluctance to liberalize prices and the slow pace adopted in the privatization process. This leaves agents without adequate signals because of the demise of central planning and because the efficient relative-price system is not yet in place. On the other hand, gradualists maintain

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<sup>1</sup> Adam Ulam, *The Vision Thing*, THE NEW REPUBLIC, June 20, 1994, at 40 (reviewing DANIEL YERGIN & THANE GUSTAFSON, *RUSSIA 2010: AND WHAT IT MEANS FOR THE WORLD* (1994)).

<sup>2</sup> For a general survey of the progress of economic reform in Poland, Hungary, and The Czech and Slovak Federated Republic, see Robert L. Harris, *Goin' Down the Road Feeling Bad: U.S. Trade Laws' Discriminatory Treatment of the East European Economies in Transition to Capitalism*, 31 COLUM. J. TRANSNAT'L L. 403 (1993).

that slow transition is inevitable and success is by no means guaranteed; the present situation was thus to be expected and foreign support becomes crucially important to drive the process.<sup>3</sup> Nevertheless, it remains unclear why price liberalization in some countries has been easier than in others. One wonders why some economies have been able to confront transition problems through shock therapy, whereas policy makers who have taken a gradualist stance have been frustrated in their attempts.

All real "orthodox" explanations, including those derived from the "new political economy,"<sup>4</sup> are dependent upon the behavior of exogenous and unpredictable variables: foreign aid, higher aggregate demand in the so-called "West," and the dynamic political situation, such as the resurgence of nationalist sentiments and Cold War hostilities. Clearly the three pillars of transition — privatization, price liberalization and currency convertibility — are extremely fragile, if not meaningless, unless they are realized within a suitable institutional/constitutional framework.<sup>5</sup>

This paper develops a different approach to transition by applying the principles of economic theory and public choice analysis to the production of law and legislation. This theory has been formalized elegantly<sup>6</sup> and subjected to rigorous empiri-

<sup>3</sup> For a general discussion of the gradualist and neoclassical approaches toward the privatization process in Eastern Europe and the Soviet Union, see Stephen S. Cohen & Andrew Schwartz, *The Tunnel at the End of the Light: Privatization in Eastern Europe*, 7 TRANSNAT'L LAW. 7 (1994).

<sup>4</sup> Cf. Carlos Asilis & Gian Maria Milesi-Ferretti, *On the Political Sustainability of Economic Reform* at 2-3, IMF Doc. PPAA/94/3 (Jan. 1994) (stating that this literature clearly cannot provide firm conclusions and a set of policy recommendations guaranteed to ensure the sustainability and success of reforms).

<sup>5</sup> The case of Russia, where privatization is a success only on paper, is typical in this context. Cf. Renzo Daviddi, *Property Rights and Privatization, in the Transition to a Market Economy. A Comparative Review*, European Institute of Public Administration, Maastricht, 1994; and M. Boycko et al., *Privatizing Russia* (Brookings Institution, 1994).

<sup>6</sup> The economic theory of regulation is based on the early seminal work in public choice. See JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT* (1962); WILLIAM H. RIKER, *THE THEORY OF POLITICAL COALITIONS* (1962); ANTHONY DOWNS, *AN ECONOMIC THEORY OF DEMOCRACY* (1957); ; KENNETH J. ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (1951); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971); Gordon Tullock, *Problems of Majority Voting*, 67 J. POL. ECON. 571,

cal testing.<sup>7</sup> It is, therefore, not surprising that the theory has found virtually universal support among social scientists interested in the operation of the political process.<sup>8</sup>

Despite the growing importance of the public choice model in economic theory, public choice methodology has yet to be utilized to examine systematically the turmoil in Russia or the former Soviet client-states.<sup>9</sup> This article attempts to fill this gap in the literature by analyzing the demise of the Soviet Union and the emergence of the new Russian Federation using a framework informed by the public choice paradigm.

Application of the principles of public choice to the recent economic and constitutional reforms in Russia has important practical and theoretical implications for public policy. On a practical level, the analysis is important because it provides the only systematic basis for predicting the future of the Russian economy. It has been clear since at least 1989 that Gorbachev's policy of *perestroika* was a failure and that neither communism nor the Soviet Union would survive the demise of this political program.<sup>10</sup> It has also become clear over the past few years that the promising economic and constitutional reforms initiated by Russian President Boris Yeltsin are not guaranteed to succeed.<sup>11</sup> What remains unclear, however, is how far Russia

578 (1959).

<sup>7</sup> See, e.g., ROBERT E. MCCORMICK & ROBERT D. TOLLISON, *POLITICIANS, LEGISLATION, AND THE ECONOMY* (1981); William F. Shughart III & Robert D. Tollison, *On the Growth of Government and the Political Economy of Legislation*, 9 RES. L. & ECON. 111, 120-24 (1986); Ann P. Bartel & Lacy Glenn Thomas, *Direct and Indirect Effects of Regulation: A New Look at OSHA's Impact*, 28 J.L. & Econ. 1, 4-10 (1985); B. Peter Pashigian, *The Effect of Environmental Regulation on Optimal Plant Size and Factor Shares*, 27 J.L. & ECON. 1, 6-7, 16-23 (1984); Barry R. Weingast & Mark J. Moran, *Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission*, 91 J. POL. ECON. 765, 780-92 (1983); R. H. Coase, *Payola in Radio and Television Broadcasting*, 22 J.L. & ECON. 269 (1979); Howard P. Marvel, *Factory Regulation: A Reinterpretation of Early English Experience*, 20 J.L. & ECON. 379, 393-403 (1977); Thomas G. Moore, *The Purpose of Licensing*, 4 J.L. & ECON. 93 (1961).

<sup>8</sup> Joseph P. Kalt & Mark A. Zupan, *Capture and Ideology in the Economic Theory of Politics*, 74 AM. ECON. REV. 279, 279 (1984).

<sup>9</sup> We leave for future research the application of our framework to the newly independent states of the former Soviet Union, and to the former Soviet client-states in Eastern Europe.

<sup>10</sup> Ulam, *supra* note 1, at 40.

<sup>11</sup> For a less than optimistic view of Russian reform, see Casper W. HeinOnline -- 4 Cornell J. L. and Pub. Pol'y. 381 1994-1995

will move towards capitalist and democratic policies, and away from the socialist and totalitarian policies that have dominated its governmental institutions for decades. The implications of this analysis for practical issues, ranging from the desirability (and nature) of future Western aid, to the likely future of nationalist sentiments, to the possibilities for a resurgence of Cold War hostilities, are profound.

Analysis of events in Russia holds the promise of resolving an important, albeit nascent, theoretical debate at the heart of the public choice movement. As explained in this article, public choice theory treats politics as a market in which politicians, bureaucrats, manufacturers, consumers, and other groups act as both demanders (through political support of all kinds) and suppliers (through tax payments and compliance with regulations for example) of legal rules. There is widespread consensus among public choice scholars that special interest groups will dominate the process of day-to-day political life.<sup>12</sup> This prediction is quite robust for a variety of reasons, ranging from the rational ignorance of consumers, to the existence of economies of scope in organizing that permit certain organizations to galvanize into effective political coalitions to press for change. Moreover, there is consensus among scholars of public choice that these special interest groups will use their political advantages to engage in rent-seeking.<sup>13</sup> Finally, there is general consensus that rent-seeking is a negative-sum game<sup>14</sup> for soci-

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Weinberger, *Davos — and Russia*, FORBES, Mar. 28, 1994, at 37; Rudi Dornbusch, *No Sense Throwing Good Money After Bad Rubles*, BUS. WK., Feb. 7, 1994, at 18.

<sup>12</sup> The size of this phenomenon is significant. Estimates of the social costs attributable to monopoly-inducing regulations range from about 3% of GNP in developed countries, e.g. the United States, to well above 10% in Least Developed Countries, e.g. in Turkey. See Richard A. Posner, *The Social Costs of Monopoly and Regulation*, 83 J. POL. ECON. 807 (1975).

<sup>13</sup> Rent-seeking refers to the process of attempting to obtain economic rents, which are payments for the use of economic capital (both human and fixed) in excess of the market price through government intervention in the market. A classic example of rent-seeking is an attempt by a single firm or subset of firms to obtain a government monopoly in a particular market niche. Such monopolies enable the firm or firms to raise prices above competitive levels. The increased income from monopoly pricing is economic rent from government regulation.

<sup>14</sup> An important exception to this is provided by those instances where the initial situation is already characterized by distortions, and the activity of the rent-seekers is such that the final (second-best) outcome is closer to that

ety, and that people therefore have an incentive to develop a constitutional order in which they agree as a group to refrain from engaging in rent-seeking — provided that others also refrain.

The theoretical deficiency in the public choice literature results from the fact that the consensus about the *desirability* of curbing rent-seeking is not matched by a concomitant consensus about the bargaining conditions under which it will be possible to do so. In other words, it is unclear under what conditions, if any, it would be possible for consumers to overcome the stranglehold of politicians, bureaucrats, and special interests, and design political rules that serve their interests.<sup>15</sup> Implicit in the work of many important scholars, such as James Buchanan,<sup>16</sup> Richard Epstein,<sup>17</sup> Jerry Mashaw,<sup>18</sup> and Cass Sunstein,<sup>19</sup> is the core assumption that it is possible for citizens to occupy a bargaining position from which a constitution that reduces rent-seeking can be crafted. Other important scholars, such as Mark Crain,<sup>20</sup> William Landes,<sup>21</sup> Richard

typical of a distortion-free economy. See NEIL VOUSDEN, *THE ECONOMICS OF TRADE PROTECTION* (1990) and Jagdish N. Bhagwati et al., *DUP Activities and Economic Theory*, 24 EUR. ECON. REV. 291, 297-99 (1984), for a formal analysis of exogenous DUP (Directly Unproductive Profit-seeking) activities.

In this paper the analysis will, however, be limited to endogenous DUP. In other words, it is assumed that interest groups attempt to create new rents, rather than seize the benefit of existing rents.

<sup>15</sup> James Buchanan described the task of the constitutional political economist as "assist[ing] individuals, as citizens who ultimately control their own social order, in their continuing search for those rules of the political game that will best serve their purposes, whatever these might be." James M. Buchanan, *The Constitution as Economic Policy*, in PUBLIC CHOICE AND CONSTITUTIONAL ECONOMICS, 103, 113 (James D. Gwartney & Richard E. Wagner eds., 1988).

<sup>16</sup> See, e.g., *id.*; BUCHANAN & TULLOCK, *supra* note 6.

<sup>17</sup> See, e.g., RICHARD A. EPSTEIN, *TAKINGS* (1985); Richard A. Epstein, *An Outline of Takings*, 41 MIAMI L. REV. 3 (1986); Richard A. Epstein, *Toward a Revitalization of the Contract Clause*, 51 U. CHI. L. REV. 703 (1984); Richard A. Epstein, *Taxation, Regulation, and Confiscation*, 20 OSGOOD HALL L.J. 433 (1982); Richard A. Epstein, *Needed: Activist Judges for Economic Rights*, WALL ST. J., Nov. 14, 1985, at 32.

<sup>18</sup> See, e.g., Jerry L. Mashaw, *Constitutional Deregulation: Notes Toward a Public, Public Law*, 54 TUL. L. REV. 849 (1980).

<sup>19</sup> See, e.g., Cass R. Sunstein, *Naked Preferences and the Constitution*, 84 COLUM. L. REV. 1689 (1984).

<sup>20</sup> See, e.g., W. Mark Crain & Robert D. Tollison, *The Executive Branch in*

Posner,<sup>22</sup> and Robert Tollison,<sup>23</sup> take the view that the constitution-making process will inevitably be dominated by special interest groups, and this process merely presents additional opportunities for politicians, bureaucrats, and special interests to obtain wealth transfers at the expense of the public-at-large. Analysis of the Russian constitutional and economic reform, which is clearly constitutional in nature, presents a unique opportunity to shed some light on this important debate within the field of public choice.

This article develops two themes: first, events in Eastern Europe can be better understood by applying public choice principles; secondly, the future of the area is path-dependent; that is, it has been determined by the bargaining dynamics that initially caused the demise of the old regime and the emergence of the new state. Section I examines the public choice literature to determine what, if anything, the public choice model can predict about the behavior of the relevant players and the likely outcomes generated by their actions. Section II analyzes the means by which organic constitutional change<sup>24</sup> can evolve in economies where rent-seeking is widely perceived as a significant welfare-reducing phenomenon, even by successful rent-seekers. Section III further develops this discussion by examining three different bargaining configurations. Section IV applies the results obtained to the case of Russia, and it emphasizes the crucial role played by the *nomenklatura*<sup>25</sup> in the transition process. The conclusions show that the future depends on whether the post-Yeltsin constitutional moment is effectively underway or is just a possibility. If the situation is the former, which is

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*the Interest-Group Theory of Government*, 8 J. LEGAL STUD. 555 (1979) [hereinafter Crain & Tollison, *The Executive Branch*]; W. Mark Crain & Robert D. Tollison, *Constitutional Change in an Interest Group Perspective*, 8 J. LEGAL STUD. 165 (1979) [hereinafter Crain & Tollison, *Constitutional Change*].

<sup>21</sup> See, e.g., William M. Landes & Richard A. Posner, *The Independent Judiciary in an Interest-Group Perspective*, 18 J.L. & ECON. 875 (1975).

<sup>22</sup> See, e.g., *id.*

<sup>23</sup> See, e.g., MCCORMICK & TOLLISON, *supra* note 7; Robert D. Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339 (1988); Shughart & Tollison, *supra* note 7.

<sup>24</sup> "Organic constitutional change" refers to reform that involves change in the essential laws organizing the government of a state.

<sup>25</sup> A member of the *nomenklatura* is an appointee of the communist party apparatus.

contrary to common belief, hopes for rapid and sound improvement are probably misplaced.

This article argues that the prospects for basic societal change are highest when the gap between the amount of wealth generated by a rent-seeking society, and the amount of wealth generated by a society that bars rent-seeking, are greatest. The greater this gap, the greater the gains to politicians, bureaucrats, interest groups, and consumers from curbing rent-seeking. This conclusion, however, depends on the various parties' ability to determine a mechanism by which the appropriate pay-offs necessary to gain an efficient constitutional contract can be made.

The article further argues that more effective organic institutional reform in Russia will allow significant gains from international trade. Germany and Japan, both of which rebounded almost miraculously from the post-war devastation of their political and economic infrastructures, enjoy, as does Russia, a well-educated, highly skilled labor force. Russia, however, has a supply of natural resources, in addition to its enviable supply of human capital, that far surpasses either Japan or Germany. Thus, the gains to be realized from efficient deployment of resources are staggering. The efficient deployment of resources, however, requires that the private sector have decision-making authority over the allocation of capital. The politicians, *nomenklatura*, and bureaucrats, who currently control the allocation of resources in Russia, will demand a heavy price for relinquishing this control.

## I. THE ECONOMIC THEORY OF LAW

This section discusses the economic theory of law as applied to day-to-day political activities, then describes the organic institutional change occurring in Russia.

### A. ECONOMICS AND THE PRODUCTION OF LEGAL RULES

Under the economic (or "interest group") theory of law, "legislation is a good demanded and supplied much as other goods, so that legislative protection flows to those groups that derive the greatest value from it, regardless of overall social welfare."<sup>26</sup> In other words, the economic theory of regulation

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<sup>26</sup> Richard A. Posner, *Economics, Politics, and the Reading of Statutes and*  
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applies generally accepted principles of rational economic behavior to decisions made by politicians, bureaucrats, and interest groups.

The economic theory of lawmaking has predictive implications starkly different from the traditional, public interest theory of regulation. The latter theory holds that regulations are designed to benefit the public by solving collective action problems and other types of market failures. By contrast, the economic theory of regulation holds that public decision-makers (politicians and bureaucrats) behave as do private-sector consumers and businesses; they attempt to maximize their own self-interest, generally at the expense of overall societal welfare.

Under the economic theory of lawmaking, interested parties form distributional coalitions in order to trade resources — in the form of power and influence, as well as money — for legislation that provides private benefits to the members of the distributional coalitions. The theory focuses on the differing organizational costs that face rival political coalitions. Efficiency considerations indicate that a group forms into an effective political coalition when the benefits from achieving wealth transfers from the legislature outweigh the costs of organizing. For a number of reasons, some groups are able to organize into distributional coalitions more cheaply than others.<sup>27</sup>

In particular, groups that have already formed into decision-making coalitions for exogenous reasons — such as lawyers and elderly people in the United States, and the military and *nomenklatura* in Russia — find the small marginal costs of diverting their activities to the political arena far outweighed by the benefits from the favorable legislation procured. The economic theory of regulation recognizes that well-organized special interest groups are better able to provide the political support that politicians need to survive than are highly diffuse, disorganized citizens. Consequently, politicians unable or unwilling to satisfy interest group constituents are driven from office by rival politicians more capable of supplying the laws that interest groups demand.

A simple example illustrates this point: Suppose a proposed piece of legislation would cost every person in Russia the ruble equivalent of U.S. \$2.00 and would transfer \$250 million to a

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*the Constitution*, 49 U. CHI. L. REV. 263, 265 (1982).

<sup>27</sup> MCCORMICK & TOLLISON, *supra* note 7, at 16-18; MANCUR OLSON, *THE RISE AND DECLINE OF NATIONS* 17-35 (1982).



particular interest group. The individual members of the public who paid for this legislation through an additional tax of \$2.00 (or, more likely, their pro-rata share of the interest on an additional \$500 million of governmental borrowing, or their pro-rata share of society's cost of conforming to some new, cumbersome government regulation designed to erect barriers to entry or to cartelize an industry)<sup>28</sup> would not find it in their interest to organize into an effective political coalition to oppose this wealth transfer. This is because the costs of organizing will be many times greater than the \$2.00 per capita cost of the legislation. Individual citizens not only would incur the costs of organizing, they would also bear the costs of obtaining information about the merits of the proposed legislation. Consequently, it would be rational for most individuals to remain ignorant about the effects of the proposed transfer rather than to incur the information and organizational costs necessary to effectively oppose the proposed wealth transfers. By contrast, the interest group beneficiary of the regulation would have incentives to expend resources up to the full amount of the proposed wealth transfer in order to achieve passage of the legislation effectuating the transfer. In the end, the lawmaking process is viewed as a market in which legal rules go to the individual or group that values them the most, as measured by its willingness and ability to pay.

Although qualifications are sometimes required, a useful generalization is that the economic theory of regulation posits that legislation will be characterized by concentrated benefits for discrete groups and widely disbursed social costs. This is because legislatures pass laws benefitting those groups able to trade political support or money in exchange for obtaining their passage.<sup>29</sup> The cost of legislation is, of course, borne by those in the worst position to object to their passage — the amorphous

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<sup>28</sup> It costs more than \$250 million to consummate a \$250 million wealth transfer to an interest group because the transfer does not take the form of a direct subsidy. Rather, the transfer is effectuated by the formation of a large, cumbersome bureaucratic framework that wastes significant resources carrying out the wealth transfer.

<sup>29</sup> Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 224 (1986) ("[M]arket forces provide strong incentives for politicians to enact laws that serve private rather than public interests, and hence statutes are supplied by lawmakers to the political groups or coalitions that outbid competing groups.").

and disaggregated public. Moreover, the realities of the political marketplace provide strong incentives for politicians themselves to search actively for issues where winners are easily identified and losers are poorly identified.

The losers pay for legislation benefitting special interest groups with increased regulatory burdens at all levels and higher prices for goods and services.<sup>30</sup> These losers are considered incapable of fighting back for several possible reasons: first, "clever" losers might believe that any "new" politicians they elected would behave in the same way as the previous ones, even if the favored coalition were no longer the same,<sup>31</sup> secondly, "ignorant" losers might not realize that they were cheated and that their welfare was falling (this is often the case with protectionism); or, finally, decision-makers at the center of the decision-making process are bureaucrats who are not easily removed.

Thus, the outcome of the political market is usually a negative-sum game. It wastes economic resources because groups expend resources organizing into effective political coalitions, sponsoring opponents of unsympathetic politicians, sanctioning non-cooperative group members, and resisting the rent-seeking activities of rival groups. If successful, rent-seeking leads to distortions. If the outcome is uncertain, the probability of successful rent-seeking reduces economic incentives to engage in productive economic activity because investors face the risk that their investments will be damaged by government regulation.

The above discussion examines the process of rent-seeking by interest groups during times of ordinary politics. The following discussion examines public choice theory during times of organic, constitutional change of the kind that has been taking place in Eastern Europe over the past several years. Unfortu-

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<sup>30</sup> Jonathan R. Macey, *Transaction Costs and the Normative Elements of the Public Choice Model: An Application to Constitutional Theory*, 74 VA. L. REV. 471, 478-80 (1988).

<sup>31</sup> A clever loser understands that no politician will ever pay attention to him, either because the loser's group has only negligible voting power or because the politician can extract only modest resources from the loser's rent-seeking activities. Thus, the loser accepts successful rent-seeking by strong interest groups and he aims at keeping the "ruling class" in office. With this strategy, the amount of unproductive, rent-seeking activities is likely to be smaller because the activities tend to be an increasing function of the turnover in the bureaucratic and the political classes.

nately, here the public choice model becomes less a paradigm than a pair of competing hypotheses.

One hypothesis is that constitution-making is no different than ordinary lawmaking. This posits that rent-seeking dominates both types of lawmaking; that constitutional change is simply a high stakes variant of ordinary lawmaking.

The competing hypothesis is that the incentives facing the interest groups and individuals drafting constitutional rules are fundamentally different than those they face during times of ordinary lawmaking. As a result of these new incentives, constitutions will likely be far more restrictive than ordinary laws in the degree of freedom afforded to interest-group politics.

Both of these hypotheses are possible. Sometimes constitution-making is indistinguishable from ordinary lawmaking. Where this happens, the ultimate political equilibrium that emerges from the constitution-making process will enhance, rather than inhibit, the rent-seeking process because the constitution-making process will be designed to increase returns to the politicians who control the process. Alternatively, the ultimate political equilibrium that emerges from the constitution-making process may inhibit rent-seeking. Predicting the constitutional framework emerging from any particular constitutional debate will depend on whose voices are heard at the bargaining table.

## B. THE ECONOMICS OF CONSTITUTIONAL CHANGE

Thus, with regard to periods of organic constitutional change, the public choice model becomes less a paradigm than a set of competing hypotheses. According to the first hypothesis, organic constitutional change is a high stakes variant of politics as usual. As Robert Tollison put it, "[c]onstitutional provisions are worth more than normal legislation to interest groups because they are more durable (i.e., harder to repeal), but they are also more costly to obtain because of stricter procedures required for passage."<sup>32</sup> According to this view, the advantage of constitutional rules is that they address the severe bargaining problem that results from non-simultaneity of performance between politicians and interest groups attempting to strike mutually beneficial deals.

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<sup>32</sup> Tollison, *supra* note 23, at 346.

This non-simultaneity of performance problem exists because the payment for a particular political favor (in the form of bribes, political support, etc.) must often be made before a politician will be called upon to deliver his end of the bargain (i.e., sponsoring a piece of legislation that cartelizes a market for a particular producer or procuring a contract with the government that cartelizes a market). When this happens, the non-simultaneity of performance between the politician and the interest group can lead to post-contractual opportunism where the politician reneges on the deal, either by refusing to perform when asked or by demanding additional payments later. This, in turn, makes the interest group less willing to supply political support in exchange for legislation in the first place.

The non-simultaneity of performance problem facing interest groups and politicians is particularly acute because the passage of the legislation in period one gives interest groups harmed by its initial passage the incentive to galvanize into an effective political coalition to fight for its repeal in period two. The spectre of an escalating cycle of rent-seeking, due to the inability of politicians to "stay bought," makes interest groups less willing to pay politicians in order to obtain wealth transfers in the first place.

Crain and Tollison<sup>33</sup> and Landes and Posner<sup>34</sup> have argued that constitutional enactments that make interest-group legislation more difficult to repeal can solve this non-simultaneity of performance problem. For example, the executive veto, by making it more difficult to repeal a law once it is enacted, increases the durability of legislation and thereby helps to solve the non-simultaneity of performance problem. Similarly, Landes and Posner argue that an independent judiciary facilitates interactions between interest groups and politicians because it prevents interest group bargains from being thwarted by subsequent legislatures:

The element of stability or continuity necessary to enable interest-group politics to operate in the legislative arena is supplied in the first instance, by the procedural rules of the legislature, and in the second

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<sup>33</sup> Crain & Tollison, *The Executive Branch*, *supra* note 20, at 560.

<sup>34</sup> Landes & Posner, *supra* note 21, at 892-94.

instance, by the existence of an independent judiciary.<sup>35</sup>

Under this variant theory, major organic changes in constitutional structure will occur in order to improve contracting problems that exist between politicians and interest groups. We will call this the "politics-as-usual" theory of constitutional change. This theory predicts that life will be worse for ordinary citizens after a period of constitutional change because interest groups and politicians will find it less costly to make agreements that transfer wealth to themselves.

However, there is a critical analytical flaw in the politics-as-usual strain of public choice theory. The executive veto and the independent judiciary — the elements identified as facilitating interest group politics by lowering the costs of rent-seeking — are elements that can, in fact, *raise* the costs of rent-seeking. As Buchanan and Tullock observed, these institutional features of constitutional structure raise the decision-costs of government and thus make rent-seeking more difficult by increasing the number of entities (judges, presidents, as well as legislators) that must be "bought off" in order to achieve passage of an interest group wealth transfer.<sup>36</sup> Moreover, in the case of the politically independent judges who comprise the judiciary, the politics-as-usual strain of public choice fails to supply any reason why these actors would enforce, rather than overturn, the interest group bargains struck in the legislature. For example, in the case of the President, the politics-as-usual strain of analysis does not explain why the President does not extract additional political support for himself from interest groups with a national base in exchange for his agreement to decline to veto a particular statute. If the executive does extract additional political support from interest groups (as public choice theory says he must in order to stay in office), then the presence of the executive veto as part of a constitutional government characterized by separation of powers *raises*, rather than lowers, the cost to interest groups of achieving passage of special interest legislation.

The point here is not that the politics-as-usual theory of constitutional design is wrong. Rather, we fully acknowledge the possibility of organic constitutional change that enhances,

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<sup>35</sup> *Id.* at 878.

<sup>36</sup> BUCHANAN & TULLOCK, *supra* note 6, at 233-48.

rather than diminishes, the efficacy of rent-seeking. Our point is simply that the politics-as-usual form of constitutional change will not be characterized by a move to a constitutional regime of separated powers with a truly independent judiciary and an independently elected executive with veto powers. Rather, as discussed below, such a regime is likely to be characterized by the dominance and control of one branch of government over its rival branches. Constitutional change that enshrines this type of revision into a nation's governmental structure, such as by creating a powerful executive that maintains political control over the legislature and judiciary, will lower the costs to interest groups of striking bargains with politicians.

However, the dismal results produced by the process of constitution-making described above are not the only possible outcomes from the process of constitutional reform. Happier results are possible because groups have incentives to curb rent-seeking during periods of constitutional change because rent-seeking is a negative-sum game — there will be more losers than winners from the process. During times of ordinary politics, all groups are in a classic prisoner's dilemma. Although everyone would be better off if a credible, enforceable agreement to prevent rent-seeking could be constructed, individual interest groups can profit if they engage in rent-seeking, provided others do not, in the absence of such an agreement. Similarly, in the absence of an agreement to restrict rent-seeking, the worst possible outcome for any individual or group would be to refrain from engaging in rent-seeking while other groups are rent-seeking. The individual or group refraining from rent-seeking would find itself subjected to numerous taxes and regulations designed to benefit other groups at its expense. Thus, rent-seeking is a classic prisoner's dilemma because all groups must engage in this activity, both in order to avoid the worst possible private outcome — massive rent-seeking at its expense — and to have the possibility of enjoying the best possible public outcome — massive governmental wealth transfers obtained without resistance from other groups.

To depict the game-theoretic aspect of rent-seeking graphically, suppose that each person in society has the choice between pursuing a strategy of seeking wealth transfers in the legislature through rent-seeking and pursuing a strategy of creating wealth by engaging in consensual, marketplace transactions. The decision to pursue one of these strategies, rather than the other, will depend on the incentives created by the constitutional structure. The decision to trade in the market-

place produces mutual gains from trade, while the decision to engage in rent-seeking retards growth and diminishes wealth. Imagine the following hypothetical payoffs in a game with two players, A and B. If neither A nor B engage in rent-seeking, but instead restrict themselves to marketplace activities, each will have a net wealth of 200. Alternatively, if both engage in rent-seeking, each will have a net wealth of 50. However, if A engages in rent-seeking and B does not, A will be able to garner a net wealth of 300, while B's wealth, which is diminished by A's rent-seeking, will be reduced to 30. Similarly, if B engages in rent-seeking and A does not, B will be able to garner a net wealth of 300, while A, (whose wealth is diminished by B's rent-seeking, just as B's was reduced by A's rent-seeking) will be reduced in wealth to 30.<sup>37</sup>

As long as the relevant individuals and groups within a society recognize that rent-seeking is a negative-sum game they will have incentives to solve the prisoner's dilemma posed by the possibility of rent-seeking during times of ordinary politics by drafting credible, sustainable constitutional rules that restrict the level of rent-seeking during times of ordinary politics:

Clearly, people have an incentive to develop a constitutional order whereby they agree to abide by the rules of trade and to refrain from plunder. A constitutional contract provides a possible escape from the prisoners' dilemma in which the members of society are otherwise caught. In effect, constitutional order is a mutually advantageous treaty among what would otherwise be warring factions — a treaty which promotes the substitution of wealth-creating trade from wealth-reducing [i.e., rent-seeking] plunder.<sup>38</sup>

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|                                |  |              |                                |
|--------------------------------|--|--------------|--------------------------------|
|                                |  | rent-seeking | consensual market transactions |
| rent-seeking                   |  | 50           | 300                            |
| consensual market transactions |  | 300          | 200                            |

<sup>38</sup> James D. Gwartney & Richard E. Wagner, *Public Choice and Constitutional Order*, in PUBLIC CHOICE AND CONSTITUTIONAL ECONOMICS 29, 33 (James D. Gwartney and Richard E. Wagner eds., 1988).

The above discussion used a bargaining model to describe the way that constitutions are likely to be shaped during times of constitutional change. Bargaining, of course, is most likely to occur when the gains from trade are highest; these gains from trade will be highest in countries where low or stagnant economic growth is coupled with high potential for growth. Under these conditions consumers can provide bureaucrats with the highest returns for acquiescing to a new constitutional order. For example, in the numerical prisoner's dilemma presented above, the market participants' joint wealth if they refrain from rent-seeking is 400, while their joint wealth if they engage in rent-seeking is 100, producing gains from trade of 300. As this difference increases, the gains from producing a constitution that restricts rent-seeking also increases. Russia is rich in natural resources and has a highly educated and technically skilled workforce endowed with a strong work ethic. This strongly implies massive potential gains from trade for producing a constitution that curbs rent-seeking.

In a nutshell, because rent-seeking is a negative-sum game, there are gains from trade to be realized by blocking this activity. There is little disagreement about this theoretical point. Thus the critical question is not whether people have *incentives* to design constitutional barriers to rent-seeking, but instead whether people can overcome the contracting problems that make it difficult to do so.

## II. TOWARDS A RENT-SEEKING TAXONOMY

In the preceding section we described the economic theory of law and the phenomenon of rent-seeking that results from rational economic actors turning their attention from markets to politics. Public choice theory predicts that constitutional creation may cause either an increase in aggregate levels of rent-seeking within a society or a decrease in such rent-seeking. Where interest groups and politicians collude in order to reduce the transaction costs of effectuating wealth transfers, organic constitutional changes within a society likely will result in increased aggregate levels of rent-seeking during the post-constitutional period. This, in turn, will reduce economic output and retard economic development because the prospect of rent-seeking reduces incentives to invest.

Alternatively, if interest groups resolve the prisoner's dilemma that forces them into rent-seeking during times of ordinary politics, they will induce organic constitutional change



that increases the transaction costs of effectuating wealth transfers and deprives politicians of power. Likely results from this latter set of conditions are reductions in aggregate levels of rent-seeking during the post-constitutional period, increases in investment incentives, and an increase in aggregate economic output.

In this section we explore how organic constitutional change affects rent-seeking. Our methodology bears similarities to the thought experiment developed by John Rawls<sup>39</sup> in which he posits a set of shared values and attempts to develop rules for a just world. Critical to the Rawlsian analysis is the notion that the bargaining parties must be aware of basic facts about the world that are relevant to their moral judgments. For this purpose, Rawls introduces the concept of a "veil of ignorance" that is used to conceal from the parties facts that might distort their moral judgments and that, in any case, are (or should be) irrelevant to those judgments.

Following Rawls, the information possessed by the parties is critical to our analysis. However, unlike Rawls, we do not have the luxury of assuming away knowledge about facts that might influence the parties' judgments in self-interested ways. In our framework, we posit that interest groups are aware of the costs and benefits of post-constitutional rent-seeking. Therefore incentives to design constitutions that deter rent-seeking clearly exist, even though there are high levels of rent-seeking during times of ordinary politics. This is consistent with observed reality: ordinary citizens constantly are complaining about organized interest groups and powerful distributional coalitions, even though they join groups and distributional coalitions that further their own interests.<sup>40</sup>

Somewhat more controversially, perhaps, we also posit that the relevant interest groups have the *technical ability* to craft a constitution that reduces the efficacy of rent-seeking by increasing the transaction costs associated with such behavior.<sup>41</sup> As Buchanan and Tullock demonstrated in *The Calculus of Consent*, different organizational structures inevitably lead to

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<sup>39</sup> JOHN RAWLS, *A THEORY OF JUSTICE* (1971).

<sup>40</sup> Jonathan Rauch, *The Hyperpluralism Trap*, *THE NEW REPUBLIC*, June 6, 1994, at 22-24.

<sup>41</sup> For a more complete discussion of the various types of constitutional provisions that can reduce rent-seeking by raising the transaction costs of organizing distributional coalitions, see Macey, *supra* note 30, at 478-80.

different supply curves for legislation.<sup>42</sup> In other words, constitutions can create organizational structures that provide a means to effectively constrain rent-seeking. Indeed, the field of constitutional economics is largely devoted to the subject of how constitutions can restrict the supply of legislation.

Six organizational structures of a constitution that clearly raise the transaction costs of rent-seeking are: (1) the use of a bicameral legislature in which each house varies in size and constituency; (2) a central bank that is free of political influence; (3) an independent judiciary; (4) an executive (preferably line-item) veto; (5) a robust federal system; and (6) a provision requiring a balanced budget.

#### A. THE BICAMERAL LEGISLATURE

Building on the work of Buchanan and Tullock, McCormick and Tollison demonstrated empirically that special interest groups will fare better in the market for legislation where legislators are distributed equally between the two houses of a bicameral legislature.<sup>43</sup> Thus, a constitution designed to curb rent-seeking would have a bicameral legislature of two houses with widely unequal distributions in membership.

Similarly, as Buchanan and Tullock show, where the members of each house of a bicameral legislature represent different constituencies, and where the two houses must concur to pass a law, it is more difficult for interest groups to ensure the passage of legislation that furthers their interests. This is because the costs to the interest groups of persuading the different political constituencies to support their interests increases as the political constituencies that must be compensated for new legislation increases. Thus, a constitution intended to impede rent-seeking would have a bicameral legislature in which different selection criteria would be used for the selection of membership in each house.

#### B. THE INDEPENDENT CENTRAL BANK

In the absence of an independent central bank, politicians can attract payoffs by manipulating monetary policy in order to transfer wealth among competing interest groups. For example,

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<sup>42</sup> BUCHANAN & TULLOCK, *supra* note 6, at 119-262.

<sup>43</sup> MCCORMICK & TOLLISON, *supra* note 7.

by causing the nation's currency to inflate at higher than expected rates, politicians can transfer wealth from creditors to debtors by enabling debtors to repay loans with currency of lower value than anticipated. Similarly, by keeping inflation below expected levels, politicians transfer wealth from debtors to creditors by enabling creditors to collect loans in currency of higher value than anticipated. Thus, by creating an independent central bank, a society can limit avenues of rent-seeking and promote economic growth and development.

### C. THE INDEPENDENT JUDICIARY

The power of judicial review by an independent judiciary can impose significant restraints on the efficacy of interest groups. This structural constitutional feature enables the judicial branch to raise further the cost to interest groups of obtaining favorable legislation by lowering the probability that interest group bargains enacted by the legislature will be upheld in the future.

### D. THE EXECUTIVE VETO

The executive veto raises the decision costs of government and thereby lowers the efficacy of rent-seeking by broadening the scope of the consensus that interest groups must achieve in order to obtain passage of legislation they prefer. In addition, while it is true that both legislators and chief executives are popularly elected, because chief executives' electoral constituencies are national in scope, they are likely to take a broader view of relevant issues than are legislators. As Terry Moe and Scott Wilson observed, "[u]nlike legislators, presidents are held responsible for virtually every aspect of national performance"<sup>44</sup> and, therefore, have an institutional preference for effective governance.<sup>45</sup>

### E. THE ROBUST FEDERAL SYSTEM

Federalism acts as a significant check on governmental excess by offering to citizens rival governmental frameworks. If

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<sup>44</sup> Terry M. Moe & Scott A. Wilson, *Presidents and the Politics of Structure*, 57 *LAW & CONTEMP. PROBS.* 1, 23 (1994).

<sup>45</sup> *Id.* at 12.

citizens perceive that rent-seeking is too prevalent at one level of government, they may exercise their "exit option" and opt for more localized governmental power. The threat of such an exit from the federal system serves as a check on government legislators and bureaucrats who tend to be highly averse to losing power. Thus, a robust federal system acts as a restraint on the ability of interest groups to influence government and effectuate wealth transfers. Douglass North observed that the closer the substitutes for an existing governmental scheme, "the fewer degrees of freedom the ruler possesses, and the greater the percentage of incremental income that will be retained by the constituents."<sup>46</sup>

#### F. THE CONSTITUTIONALLY REQUIRED BALANCED BUDGET

Government can constrain rent-seeking by imposing a constitutional requirement that the government refrain from deficit financing. Such a requirement would facilitate resolution of the collective action and rational ignorance problems that face consumers during times of ordinary politics. Bureaucrats and interest groups use deficit financing both to increase aggregate levels of wealth transfers to interest groups and to disguise the true costs and benefits of their legislative enactments. They accomplish this by shifting the payments to the future, thus raising the amount of information ordinary citizens must acquire before they find it worthwhile to form into effective political coalitions to oppose rent-seeking. By requiring a balanced budget the disadvantages suffered by ordinary citizens in their efforts to galvanize into effective political coalitions to oppose rent-seeking can be significantly reduced.

### III. SOME BARGAINING CONFIGURATIONS

Even under the twin assumptions (knowledge about the effects of rent-seeking coupled with the technological ability to design constitutional structures to curtail rent-seeking) adopted under the bargaining framework presented in this article, it is still not inevitable that the relevant parties will agree to a constitutional regime that curbs rent-seeking. Rather, the outcome of the bargaining that occurs during the formulation of

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<sup>46</sup> Douglass C. North, *A Framework for Analyzing the State in Economic History*, 16 *EXPLORATIONS IN ECON. HIST.* 249, 253 (1979).

constitutional rules will depend on the preferences and expectations of the bargaining parties, which, in turn, will depend on their expectations about the post-constitutional world. Moreover, a host of bargaining problems may prevent the parties from reaching an agreement despite the existence of significant potential gains from trade.

The participants in the constitutional bargaining game are involved in real-world social contracting. Unlike the Rawlsian veil of ignorance,<sup>47</sup> behind which the bargaining parties are assumed to be ignorant of their status in the post-bargaining world, the individuals and groups will be fully aware of their likely roles in a post-constitutional order. Critical to this analysis is the possibility that some groups will expect to be net winners in a rent-seeking society. This is due to the fact that, even though rent-seeking is a negative-sum game overall, for some individuals and groups (for example, politicians, bureaucrats, lawyers, lobbyists, and the *nomenklatura*) rent-seeking is clearly a positive-sum exercise. The ability of successful rent-seekers to peek behind the constitutional-stage bargaining veil to get a view of their role in the constitutional order will cause them vigorously to resist efforts to forge constitutional rules that eliminate the demand for their services by reducing aggregate levels of rent-seeking.

Thus, the identity of the groups actively involved in determining governmental structure and allocations of power during times of organic constitutional change will be critical to the outcomes generated by the bargaining process. There are three possible bargaining configurations, each of which leads to varying results in terms of overall social welfare.

#### A. CONSUMER CONTROL OF THE PROCESS: THE CONSTITUTIONAL MOMENT

One possible bargaining configuration is that the net losers from rent-seeking (for ease of exposition we will call these net losers "consumers") will exclude the net winners (for ease of exposition we will call the net winners from rent-seeking "bureaucrats") from the bargaining table or else they will eliminate their influence once they are there. Where this occurs, the consumers will design constitutional rules that structurally impede rent-seeking. This will lead to strong incentives to

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<sup>47</sup> RAWLS, *supra* note 39.

invest in productive activities because entrepreneurs will no longer have to worry about the spectre of governmental expropriation of their investments. This, in turn, will lead to high levels of economic growth and prosperity.

At first blush it might seem unlikely that consumers will be able to exclude bureaucrats from the bargaining table. After all, it is the bureaucrats who control governmental decision-making during times of ordinary politics, and it stands to reason that such bureaucrats will influence, if not control, the public decision-making process during times of organic constitutional change. However, it must be remembered that consumers have strong incentives to develop a constitutional order that limits rent-seeking.

Rational ignorance deprives consumers of the incentive to galvanize into effective political coalitions to oppose statutes passed during the course of everyday politics because the transaction costs of forming such coalitions outweigh the benefits in the form of savings from wealth transfers. However, this cost-benefit calculation changes when organic constitutional rules are being considered. This is because the impact of constitutional rules is much higher than the impact of ordinary laws because such rules will determine the ability of government to affect all of a citizen's present and future wealth. Thus

we would expect the citizen-consumer-taxpayer to play a larger role in constitutional processes than in normal political processes . . . [because] the individual voter's stake is . . . larger when considering constitutional issues. At the relevant margins of behavior, then, we expect more voter impact on constitutions than on regular elections.<sup>48</sup>

Consumers may therefore be able to galvanize into an effective political coalition and freeze the bureaucrats out of the process. Constitutional moments are the periods in which consumers overcome the free-rider and rational ignorance problems, resulting in the prisoner's dilemma of ordinary politics, in order to craft constitutional rules that impede rent-seeking.<sup>49</sup> The defining characteristic of a constitutional moment is that it represents an agreement among people to restrict their rent-

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<sup>48</sup> MCCORMICK & TOLLISON, *supra* note 7, at 127.

<sup>49</sup> See BRUCE ACKERMAN, *WE THE PEOPLE* 270-72 (1991).

seeking activities in exchange for an agreement by others to do the same.<sup>50</sup>

#### B. BUREAUCRATIC CONTROL OF THE PROCESS: POLITICS AS USUAL

Just as consumers have incentives to initiate and to gain control of the process of constitutional formation in order to make themselves better off at the expense of bureaucrats, so too do bureaucrats have incentives to initiate and to gain control of the process of constitutional formation in order to make themselves better off at the expense of consumers. To achieve this end, the bureaucrats will attempt either to exclude the consumers from the bargaining table or to ignore their interests once they are there.

The bureaucrats can benefit from constitutional change to the extent they are able to design organizational rules that solve the contracting problems that exist between politicians and rent-seekers. By doing this the bureaucrats can increase the demand for their services. Bureaucrats act as brokers among consumers and various groups of producers; they "establish an equilibrium" by efficiently pairing these demanders and suppliers of legislation.<sup>51</sup> From the bureaucrats' perspective, constitutional rules differ from ordinary rules only with respect to their durability. The greater durability of constitutional rules makes them more valuable to special interest groups.

For this reason, politicians will press for constitutional changes that increase the durability of special interest legislation and solve the non-simultaneity problems that exist between politicians and rent-seekers in order to increase the demand for their services.<sup>52</sup> The bureaucrats will attempt to exclude the consumers from the process of constitutional change because the interests of the consumers are diametrically opposed to those of the bureaucrats.

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<sup>50</sup> *See id.*

<sup>51</sup> *Id.* at 62.

<sup>52</sup> Crain & Tollison, *Constitutional Change*, *supra* note 20, at 165, 167; Landes & Posner, *supra* note 21, at 888-91.

### C. THE BARGAINING GAME

The final possibility is that neither the bureaucrats nor the consumers are able to exclude the other or to ignore the others' influence. In this case, each group will have to take the interests of the other into account. In particular, the bureaucrats, who expect to lose from reductions in rent-seeking, may be able to form a blocking coalition to impede consumers from reaching a welfare-increasing (on aggregate) constitutional change. This results because organic societal changes often require the support of a super-majority. Side payments from consumers to bureaucrats are a possible solution. Their feasibility, however, is greatly reduced by their likely size, as well as by the existence of severe bargaining problems, particularly the non-simultaneity of performance and social problems.

With regard to non-simultaneity, the trade gains from setting constitutional rules to impede rent-seeking are *future gains* to be realized from increases in productivity and aggregate social wealth. Consequently, bureaucrats will be asked to make immediate sacrifices by accepting constitutional impediments to rent-seeking and power cuts in exchange for promises of future compensation from consumers. Such compensation would, however, become more difficult to enforce in the new post-constitutional order. In addition, side payments to the bureaucrats would, of course, be illegal: in principle, civil servants are supposed to act in the best interests of society. Bureaucrats would actually endanger their power base by accepting explicit payments.

The contracting problems are exacerbated by the fact that the restrictions on rent-seeking behavior that consumers bargain to obtain will necessarily require constitutional measures that reduce the power of the bureaucrats. These restrictions will reduce the bureaucrats' power to enforce promises made by consumers in the post-constitutional order.

In addition to simultaneity of performance problems, there are also likely to be significant social obstacles to contracting. The bureaucrats' claims to power derive from a complex combination of control over police and military power and public support. Public support derives from the bureaucrats' ability to claim to be acting in the best interests of society. The sheer size of the side payments necessary to induce the bureaucrats to acquiesce in the consumers' efforts to design a constitution that impedes rent-seeking is potentially so large that bureaucrats would endanger their power base by accepting such payments.



The acceptance of such payments would not only amount to an admission that the bureaucrats were interested in advancing only their own personal welfare, and not the welfare of the public they ostensibly were hired to serve; they would also be illegal. The public would take the position that such side-payments belonged to them, rather than to the bureaucrats.

The likely mechanism for solving these contracting problems is to keep the bureaucrats in office in exchange for their agreement to refrain from interfering with the consumers' activities in the market. Keeping the bureaucrats in office allows them to keep politicians at bay in ordinary decision-making.

#### D. BEYOND BARGAINING

In a path-breaking book, Mancur Olson posits a non-bargaining alternative mechanism by which a society can free itself from the welfare-reducing distributional coalitions.<sup>53</sup> Consistent with the analysis presented here, Olson begins with the assumption that interest groups forming distributional coalitions have powerful incentives to seek a larger share of the national income, even when this rent-seeking "greatly reduces social output."<sup>54</sup> Similarly, Olson recognizes the fact that interest groups' rent-seeking "reduces an economy's dynamism and rate of growth,"<sup>55</sup> and that interest groups "increase regulation, bureaucracy, and political interventions in markets."<sup>56</sup>

While Olson recognizes that constitutional rules can present obstacles to passage of special-interest legislation,<sup>57</sup> he does not specify the conditions under which a country is likely to adopt a constitution that impedes rent-seeking. Instead, Olson posits an alternative mechanism by which distributional coalitions can be displaced:

[C]ountries whose distributional coalitions have been emasculated or abolished by totalitarian government or foreign occupation should grow relatively quickly after

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<sup>53</sup> OLSON, *supra* note 27, at 37.

<sup>54</sup> *Id.* at 75.

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.* at 90 (citing Switzerland as a country with a constitution that presents obstacles to special interest legislation).

a free and stable legal order is established. This can explain the postwar "economic miracles" in the nations that were defeated in World War II, particularly those in Japan and West Germany. The everyday use of the word *miracle* to describe the rapid economic growth in these countries testifies that this growth is not only unexpected but outside the range of known laws and experience.<sup>58</sup>

Thus it stands to reason that if the above assumptions (knowledge about the effects of rent-seeking coupled with the technological ability to design constitutional structures to curtail rent-seeking) obtain, consumers who are unable to reach an agreement with bureaucrats will have strong incentives to foster revolution in order to undermine the continued stability of the dominant distributional coalitions that are undermining their society's potential for growth.

#### IV. RUSSIA: THE BARGAINING MODEL ALTERNATIVES

Unfortunately, it is not possible to apply Mancur Olson's paradigm to the Russian experience because there has been no abolition of that country's distributional coalitions by totalitarian government or foreign occupation. Olson's approach has indeed been at the basis of the shock-therapy approach to privatization in the Czech Republic and in Poland. However, the very need to emasculate or brainwash the bureaucracy, as was to some extent the case, for example, in Poland, explains why gradualism is still the *leitmotiv* in the former U.S.S.R. In the former U.S.S.R., most, if not all, of the country's basic distributional coalitions remain in place. Enterprises escaped from central planning into an endless series of negotiations with the bureaucracy over subsidies, prices, and output, rather than into a *true* market environment. Thus, this section of the article explores the implications of the bargaining analysis as it applies to Russia.

Despite the fact that Russia has human and natural resources that far surpass those of Germany and Japan, the two nations that advanced from ruin to the status of economic superpowers in fifteen years,<sup>59</sup> the fall of the Soviet empire has

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<sup>58</sup> *Id.* at 75-76.

<sup>59</sup> Ulam, *supra* note 1, at 40.

not brought prosperity. Instead, gross domestic product (GDP) is at least one-third smaller than it was in 1985, and inflation is not yet under control.<sup>60</sup>

Ironically, Russia's problem is precisely that it has not suffered a major military defeat or an equivalent shock. The dominant interest groups, particularly the *apparatchiks* and members of the economic bureaucracy, remain in place,<sup>61</sup> "unwilling to carry out the transition process, which would mean the loss of power and privileges."<sup>62</sup> The actions of the Russian parliament, which opposed and obstructed economic reform whenever possible, provide ample evidence of the problems for meaningful reform. Even with the ratification of the new constitution and the election of an entirely new legislature in December of 1993, conservatives and communists continue to dominate the government and hinder meaningful reform.<sup>63</sup>

Thus in Russia, even though the ideology of the communists was discredited, the interest groups and bureaucrats that thrived under communist rule continue to control the country's resources. These bureaucrats and interest groups hold reform hostage.

#### A. A CONSTITUTIONAL MOMENT FOR RUSSIA?

In terms of the bargaining model presented above, clearly the first possibility, which posits consumer control of the process with bureaucrats and interest groups agreeing to rules that curb rent-seeking, has not taken place. The recent constitutional reform failed to lead to any substantial reduction in the power and influence of the bureaucracy over the Russian economy.

The new constitution preserves the old bureaucracy almost intact under the title "The Government of the Russian Federation." This branch of the Russian government is currently led by the Prime Minister, Viktor Chernomyrdin. Chernomyrdin, a self-described "red manager," is a former *apparatchik* from the

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<sup>60</sup> *Id.*

<sup>61</sup> Historically, an *apparatchik* works within the bureaucratic apparatus of the communist party.

<sup>62</sup> Enrico Colombatto, *The Integration of the East and the Options for the West*, 3 JOURNAL DES ECONOMISTES ET DES ETUDES HUMAINES 273, 275 (1992).

<sup>63</sup> See Peter Galuska & Patricia Kanz, *Crunch Time in Russia*, BUS. WK., Feb. 7, 1994, at 42; Yuri N. Afanasyev, *Russia's Vicious Circle*, N.Y. TIMES, Feb. 28, 1994, at A17.

mammoth Russian natural gas enterprise.<sup>64</sup> Judging from his past, he clearly seems averse to reform, and his cabinet is filled with like-minded men.<sup>65</sup> According to a recent *Newsweek* article, "[t]he new government . . . is packed with Soviet-style bosses: a former factory director, a collective-farm director, a central-bank chief who believes in state subsidies for industry . . . . They are . . . men for whom support of Russia's inefficient industry and agriculture is second nature."<sup>66</sup> Under this arrangement, massive government subsidies to the country's inefficient and technologically outdated industries are sure to continue, while market reform and legitimate privatization will undoubtedly be stalled.

Moreover, the privatization the bureaucrats actually allowed has been a sort of cruel joke as the former managers remain in control of industry and need only telephone Moscow to obtain government subsidies provided by the *nomenklatura*. Central planning was canceled, but the centralized bureaucratic system is alive and well. Many large entities that have been privatized enjoy state subsidies and monopoly power and lack incentive to operate efficiently because they can more easily devote resources to rent-seeking. Those government officials in charge of the process are in many cases abusing their power in order to effectuate wealth transfers to themselves and their powerful supporters. Although nearly forty percent of all Russian workers are now employed by privately owned businesses,<sup>67</sup> bureaucrats and the privileged *nomenklatura* class maintain control over and secure much of the profits from these businesses. According to a recent *Business Week* article, "increasingly powerful public-sector managers profit tremendously from the sell-offs [of government businesses], often gaining controlling stakes or at least veto power in their companies. Some set up profitable businesses on the side, such as banks or equipment suppliers."<sup>68</sup> In addition, the *Washington Post* recently reported that in most cases privatization has been

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<sup>64</sup> Margaret Shapiro, *Russia's Premier Has Reformers Seeing Red*, WASH. POST, Feb. 11, 1994, at A33, A38.

<sup>65</sup> *Id.* at A38.

<sup>66</sup> Dorinda Elliot & Michael Elliot, *Boris is Finally a Russian*, NEWSWEEK, Jan. 31, 1994, at 44, 45.

<sup>67</sup> Galusska & Kranz, *supra* note 63, at 43.

<sup>68</sup> Peter Galusska & Susan B. Garland, *Russia: From Shock Therapy to Shock Absorbers*, BUS. WK., Jan. 31, 1994, at 49.

merely the "replace[ment of] government-owned enterprises with joint stock companies controlled by the nomenklatura and criminal mafias."<sup>69</sup> Obviously, this type of "sham privatization" is not going to lead to the increased productivity and efficiency that the Russian economy so desperately needs. In order for Russia to move forward economically, the bureaucrats must abandon their self-interest (or be bought off or overthrown) and make more legitimate efforts to move government-owned industry into the hands of entrepreneurs.

#### B. BUREAUCRATIC CONTROL OF THE PROCESS: POLITICS AS USUAL

The question, then, is which of the other two possibilities — complete bureaucratic control of the process or bargaining between bureaucrats and consumers — best describes the ongoing situation in Russia. It does not appear that the bureaucrats gained complete control of the process of constitutional formation. They did not exclude the consumers from the bargaining table entirely and thus were unable to ignore consumer interests completely. Evidence of this derives from the fact that bureaucrats have not been able to implement organizational rules that are entirely in their best interests in terms of solving the contracting problems between politicians and rent-seekers.

Although the new constitution failed to break the bureaucrats' powerful hold over the government, it was not a total loss for consumers. The constitution contains several of the provisions described earlier that work to increase transaction costs between special interest groups and politicians. For example, the constitution provides for three separate and independent branches of government — a legislature, an executive, and a judiciary.<sup>70</sup> It also provides for an independent central bank exclusively responsible for monetary emission.<sup>71</sup> In addition, a complex system of checks and balances deters abuses of power by any one of the three branches of government.<sup>72</sup> These pro-

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<sup>69</sup> Abraham Brumberg, *Russian Reform Humbug*, WASH. POST, Jan. 28, 1994, at A23.

<sup>70</sup> See CONST. OF THE RUSSIAN FED'N, chs. 4-7.

<sup>71</sup> See *id.*, ch. 3, arts. 75, 76.

<sup>72</sup> For a detailed description of the relationships between the branches of the new Russian government, see *Framework or Frame-up?* ECONOMIST, Dec. 18, 1993, at 47.

visions, as discussed previously, impede the efforts of rent-seekers by increasing the number of people who need to be reached (or bought) in order to obtain favorable legislation.

In addition to the structural impediments described above, Chapters 1 and 2 of the constitution work to restrict rent-seeking by guaranteeing that an impressive array of rights will not be infringed upon by the government.<sup>73</sup> The Russian government may choose to ignore these rights, but their mere presence serves as limitations on legislative and executive power and indicates consumer influence in the constitutional reform process.

Moreover, the serious political unrest that accompanied the transformation process makes it clear that something like a constitutional moment is at least a possibility in Russia. This possibility acts as a significant constraint on the degree of freedom bureaucrats enjoy. In particular, they may be encouraged to act in order to increase the efficiency of the present system, thereby reducing the perceived gap between potential and actual income and delaying a constitutional moment that could be dominated by consumers. The resulting larger share of the rent-seeking pie at the expense of the politicians would not be enough to compensate for the smaller size of the pie itself. Consequently, the real issue is whether the bureaucracy is capable of improving the economic performance of Russia, a doubtful proposition both because the situation already may be out of control and because of the limited skills of many bureaucrats.

Notwithstanding the above concerns, the bureaucrats themselves have been unwilling to promote full constitutional change for two reasons. On the one hand, the role consumers would likely play during the constitutional moment would be a threat to the bureaucrats' power. In addition, a confused political situation without constitutional change deprives politicians of their bargaining power, which is based on personal credibility and expected length of stay in office, and thereby favors the role of the bureaucrat, who is the only solid rock in the storm.

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<sup>73</sup> See CONST. OF THE RUSSIAN FED'N, chs. 1 & 2.

### C. THE BARGAINING GAME IN RUSSIA

The third possibility offers the best representation of the situation in Russia. Neither the bureaucrats nor the consumers could completely exclude the other from the bargaining table, or ignore the other's influence. Each group takes the interests of the other into account, at least to some extent.

Unfortunately, a variety of institutional factors have impeded consumers' ability to strike a bargain with the bureaucrats that would result in constitutional change and a reduction in aggregate levels of bureaucratic waste caused by rent-seeking. No mechanism was devised to effectuate side-payments from consumers to bureaucrats because, as explained above, the benefits flowing from the enactment of constitutional rules that impede rent-seeking are *future gains* to be realized from increases in productivity and aggregate social wealth. Consequently, bureaucrats will be asked to make immediate sacrifices in their freedom to bargain by accepting constitutional impediments to rent-seeking in exchange for promises of future compensation from consumers.

One possible means of avoiding this bargaining trap is through Western aid. Unfortunately, Western taxpayers do not appear to be willing to permit their funds to be used to pay bureaucrats to refrain from interfering with market processes or to subsidize the organization of consumers into effective pressure groups. What is needed is a means of packaging aid from the West in order to accomplish this objective without appearing to do so.

As Jan Winiiecki observed in his innovative article on the problems encountered in reforming Soviet-style economies, there are two principal types of rents enjoyed by existing elites in Russia.<sup>74</sup> First, and most obviously, are the kickbacks by which managers and other members of the ruling elite divert resources to others in exchange for private gains for themselves. Second, and perhaps more importantly, are the payments that members of the bureaucracy receive in exchange for making appointments.

The expected loss of these rents by people in power is the major obstacle to reform.<sup>75</sup> When an enterprise is privatized

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<sup>74</sup> Jan Winiiecki, *Why Economic Reforms Fail in the Soviet System — A Property Rights-Based Approach*, 28 *ECON. INQUIRY* 195 (1990).

<sup>75</sup> *Id.* at 205.

(legitimately) bureaucrats lose their powers of appointment, and the people running the enterprise, even if they remain in control, lose the ability to obtain funds from kickbacks. Thus, both types of rents disappear in the event of privatization.

Consistent with the bargaining framework advanced here, one means of resolving this dilemma is to have entrepreneurs pay the *apparatchiks* for the right to set up private firms. Unfortunately, the existing legal structure in Russia strongly discourages such solutions. Receipt of a payment in exchange for permission to set up a private firm would constitute a bribe under Russian law — a criminal act.<sup>76</sup> By contrast, rent extraction in appointments is either perfectly legal or, at worst, in the "grey area" between the improper and the criminal.<sup>77</sup> Consistent with this bargaining approach, it would be far better if bribes to accomplish privatization were decriminalized, even encouraged, while appointments to managerial posts within industrial firms by bureaucrats were criminalized. It is not clear, however, how such a change could be accomplished.

The only viable means of solving the contracting problems that impede reform is to keep the bureaucrats in office and obtain a promise from them that they will refrain from interfering with the operation of the markets. Unfortunately, the bureaucrats have incentives to act opportunistically in order to enhance their power by creating crises that may only be resolved by a powerful state which, in turn, would be anchored on a powerful and centralized civil service. Thus the dramatic rise in criminal activity in general, and mafia-related violence in particular, is actually consistent with the self-interests of Russia's politicians and bureaucrats in that these events increase the public's demand for a powerful state.

The demise of Gorbachev, and Yeltsin's subsequent rise to power, can be seen as a textbook example of the bargaining model described in this paper. As Tatyana Tolstaya so cogently observed, as long as Gorbachev was in power as head of the Communist party, Yeltsin's role as President of Russia was symbolic at best and meaningless at worst.<sup>78</sup> Until Gorbachev's demise, Yeltsin was just another "toy 'president'"<sup>79</sup> of the other republics within the former Soviet Union, and the

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<sup>76</sup> *Id.* at 206.

<sup>77</sup> *Id.*

<sup>78</sup> Tatyana Tolstaya, *Boris the First*, N.Y. REV. BOOKS, June 23, 1994, at 3.

<sup>79</sup> *Id.* at 4.



presidents of the other republics realized significant gains from overthrowing Gorbachev. In doing so, they obtained real power:

They finally had the prospect of unlimited rule at home. They wouldn't have to account to 'Moscow' or crawl on their bellies to send tithes: rugs, diamonds, cognac, money, porcelain vases of human height with portraits of the Great Russian Boss . . . . Yeltsin would have to share with his fellow bandits, especially since this would allow him to seem a great democrat, and pronounce those sweet words, sovereignty, independence, equal rights.<sup>80</sup>

Thus, the demise of the former Soviet Union can be attributed to Yeltsin's quest for power; he traded an imperial empire for greater power to the local rulers in their own country. His bargaining partners were power brokers, such as Georgia's Edward Shevarnadze, who stood to gain significant power and autonomy in their newly independent states. The twin promises of economic reform and democracy were mere smoke screens to disguise the power grab. Once Yeltsin achieved his goal of becoming President of Russia, the *apparatchiks* and bureaucrats realized there were powerful incentives to resist change.<sup>81</sup>

These same *apparatchiks* and bureaucrats are now a significant restraint on Yeltsin, for they are likely to revolt if he places their dominance in jeopardy by changing the command and control nature of Russia's economic system.<sup>82</sup> Examples of such changes include the current system of side payments — usually in the form of goods for which there is a shortage and a high black market price — and kickbacks from managers of industrial firms to bureaucrats and *apparatchiks*.<sup>83</sup> Also

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<sup>80</sup> *Id.*

<sup>81</sup> This did not occur earlier because before Gorbachev there had never been a serious threat of constitutional change, and thus no need for previous leaders to trade formal imperial power for substantial local power.

Gorbachev consequently gave in to pressures for constitutional change both because he hoped to trade an increasingly shaky absolute power (due to the economic crisis and the increasingly authoritative *nomenklatura*) for greater power in a less totalitarian empire, and because of the severe financial economic crisis in the U.S.S.R.

<sup>82</sup> Winiecki, *supra* note 74, at 202.

<sup>83</sup> *Id.* at 199.

threatened is the receipt of private benefits by the managers of inefficient, state-supported enterprises when they delegate

workers from auxiliary factory divisions to build country houses at sharply reduced prices, to build one-of-a-kind furniture for the apartment of a superior on the same basis, etc. The relative unimportance of efficiency allows managers to absorb, without being held accountable, the costs of these kickback activities. Leakage of wealth thus takes place not only through the losses incurred and gains foregone by incompetent managers, but also because of time and effort spent on rent seeking activities.<sup>84</sup>

Last, but not least, existing bureaucrats have strong incentives to resist change because it might eliminate one or more layers of the bureaucracy. Such reform would not only harm the bureaucrats, whose employment would be terminated, but also the higher level *apparatchiks* because they would be able to command fewer rents in exchange for making such appointments.<sup>85</sup> More generally, the *apparatchiks* would most strongly resist attempts to move Russian society toward a market-based meritocracy, since such a change would undermine the power of the *apparatchiks* to make appointments. This is why the *nomenklatura* has never been abolished for managerial posts in the Russian economy.<sup>86</sup> Ironically, since it is in industry that there are the best opportunities for kickbacks, it is there that the existing elites most strongly resist moving to a market-based system which would threaten the *nomenklatura*. By contrast, in agriculture, where there are fewer opportunities for the *apparatchiks* to obtain rents from the *nomenklatura* they appoint, the resistance to market forces has been less intense. Thus, the history of Russia (and many Eastern European economies) "shows some partly successful reforms of state agriculture . . . . To date no reforms of state industry, based on general parameters, accountability, or merit, have been successful."<sup>87</sup>

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<sup>84</sup> *Id.* at 200.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.* at 202.

<sup>87</sup> *Id.*

## CONCLUSION

As Douglass North observed, the persistent tension between the organizational structure of a government that maximizes the income of its ruler (and the ruler's supporters), and an efficient system that reduces transaction costs and encourages economic growth, is the "root cause of the failure of societies to experience sustained economic growth."<sup>88</sup> The way this tension between the interests of the ruler and the interests of the governed is resolved in Russia over the next few years will determine the economic future of that country. Of particular importance is whether the leaders can arrive at a bargaining solution with consumers that allows both sides to enjoy the benefits from trade that accrue as a result of a reduction in aggregate levels of rent-seeking. It is by no means clear they will be able to do this.

Consistent with basic principles of path-dependence, it is inevitable that the future of reform in Russia will be determined by the initial conditions under which the collapse of the Soviet Union occurred. In particular, the absence of a meaningful external force to remove the stranglehold exerted by preexisting interest groups strongly suggests that the dramatic and effective economic reforms that took place in post-War Germany and Japan will not be seen in Russia. The open question, of course, concerns possible scenarios for the future. If the bureaucrats continue to feel threatened and are not successfully bought off, either by outside powers or by internal interests, the situation in Russia will continue to worsen. However, if a mechanism can be designed for paying off the bureaucrats, the situation will significantly improve. How much improvement will depend on the nature of the bargain struck with the bureaucrats and the price at which it is reached.

Thus, until means can be devised for paying off Russian bureaucrats or for removing them from power entirely (an unlikely prospect), real reform is impossible. To paraphrase Tatyana Tolstaya, in the Russian tradition, we feel sorry for the loser — Russia.<sup>89</sup>

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<sup>88</sup> North, *supra* note 46, at 253.

<sup>89</sup> Tolstaya, *supra* note 78, at 7.

