Political culture and economic decline

Arye L. Hillman \textsuperscript{a,b}, Heinrich W. Ursprung \textsuperscript{c,*}

\textsuperscript{a} Department of Economics, Bar-Ilan University, Ramat Gan, 52900, Israel
\textsuperscript{b} CEPR, London, EC1V 7RR, UK
\textsuperscript{c} Department of Economics and Statistics, University of Konstanz, Postfach 5560, Box D-138, 78457 Konstanz, Germany

Received 1 September 1999; received in revised form 1 January 2000; accepted 1 January 2000

Abstract

In societies with a political culture of rent seeking, social norms do not disallow the use of political office for privileged distribution. Societies with such norms tend to be characterized by political insiders and outsiders. We describe the attendant contestability of rents in the two domains of rent seeking when insiders seek politically assigned benefits and outsiders seek to re-position themselves as insiders, and show how successive stages of political liberalization result in economic decline. The model is considered against the background of the political liberalization that occurred in the post-socialist societies and the observed tendencies for economic decline, and at times economic collapse, in various of these societies' economies. © 2000 Elsevier Science B.V. All rights reserved.

\textit{JEL classification:} H11; P30
\textit{Keywords:} Political culture; Transition; Rent seeking; Political liberalization

According to the head of Russia's central bank, billions of dollars of its foreign exchange reserves have, over a five year period, been secretly administered by an offshore company. The company's existence was first revealed on February 1 (1998) by the country's chief prosecutor, Yuri Shuratov, who had been investigating the high-spending central bank since last August's (1998) financial crash.

* Corresponding author. Fax: +49-7531-88-3130.
\textit{E-mail address:} heinrich.ursprung@uni-konstanz.de (H.W. Ursprung).

0176-2680/00/$ - see front matter © 2000 Elsevier Science B.V. All rights reserved.
PII: S0176-2680(00)00005-7
He resigned ostensibly for health reasons the next day. . . . A former finance minister, Boris Federo, says he queried the arrangements in 1993, but was told to mind his own business. “They were simply allowing friends to earn handsome profits,” he suggests.

The Economist, February 13, 1999.

An anti-corruption law was adopted by the Russian duma (parliament) in November 1997. The law did not designate as illegal the participation of an official figure in a commercial activity for personal benefit. The law did not designate as illegal the use of an official position to divert state resources into private commercial entities for personal benefit, with the involvement to this end of relatives and/or other persons. The law did not designate as illegal the granting privileges to private commercial structures by an official figure for personal benefit.

Observed in the IDEM Foundation, 1998 (see also Levin and Satarov, 2000).

We did not neglect institutional development.


1. Introduction

Socially beneficial competition is efficient in attracting resources to eliminate rents; socially disadvantageous competition is inefficient in attracting resources to the creation and contesting of rents. When rents are politically assigned, political liberalization, by expanding the scope of the latter type of competition, can therefore increase social losses. In a society with a sustained culture of rent seeking, political liberalization can consequently be associated with economic decline.

By a culture of rent seeking, we mean that individuals in a society perceive influence over political allocation to be a primary source of private benefit, and that political behavior is accommodating by assigning privileged private benefit in response to rent-seeking overtures. To acquire wealth and to improve their personal positions in life, individuals therefore focus their attention on seeking beneficial decisions from government. 1

We shall describe the behavior of the insiders and outsiders in such a rent-seeking society. Insiders have direct access to privileged benefit from political decisions and expend resources in seeking to influence these decisions in their

---

1 See Tullock (1988).
favor. The privileged benefits available to the insiders provide incentives for outsiders to compete for insider positions that become available as insiders retire over time (or are retired).

The persons who are in government are distinct from insiders (and outsiders), and seek maximal political gain from allocating benefits among insiders, but are also responsive to discontent of outsiders.

As the society proceeds through successive stages of openness in influence over political allocation, we evaluate the total resources used by insiders contesting politically assigned rents and by outsiders seeking to re-position themselves to become insiders. Under reasonable circumstances, the value of resources used in rent seeking by insiders and outsiders increases with stages of political openness.

Our beginning is in the institutions of political monopoly. Here insiders in the single or monopoly interest group use resources to subjugate outsiders, and outsiders use resources in seeking to become insiders. The replacement of political monopoly by political competition allows a number of insider-groups to compete for politically assigned favors. Outsiders continue to use resources to contest insider positions. A further stage of political openness eliminates the barriers that have sustained the distinction between insiders and outsiders and allows previous outsiders to join any of the now non-exclusive interest groups. In a final stage of political liberalization, political entry barriers altogether disappear; persons who so wish can form their own interest group and the number of competing interest groups can increase.2

A further step, which we do not model but can quite naturally follow, is retrogression. If political liberalization makes the population increasingly economically worse off, the population can become increasingly sympathetic to reversion to illiberal regimes under which they were economically better off.

2. Hobbes, Locke and our model of political culture

In common with our model, Hobbes (1651) also associated political liberalization with social disadvantage. Hobbes proposed that, left to themselves in the absence of the authority of government, men and women would devour one other. To protect people from their own base nature, he proposed government by a "leviathan", who would have absolute authority and who would own all property and would subjugate all people. By preempting anarchic unproductive contestability of wealth, the leviathan leaves people no alternative but to be productive. Hobbes surmised that rational enlightened people would voluntarily subject themselves and their property to the authority of the leviathan, so as to avoid the anarchy that would otherwise prevail. He thus proposed that people would realize that political liberalization was to their detriment.

---

2 On entry barriers to political competition, see Tullock (1965).
Hobbes’ position contrasts with that of Locke (1690). Locke rejected rule by an authoritarian leviathan, who constrained individual freedom. Men and women are, in Locke’s view, born into a natural state of freedom. The only legitimate government is therefore one that is accountable to the people (or more particularly, as he understood, to people of property).

The contrary positions of Hobbes and Locke set the merits of social order against the merits of individual freedom (see Rowley, 1999). Locke’s natural state of freedom is inconsistent with the political monopoly of the leviathan, but for Hobbes, the political liberalism sought by Locke opens the way to anarchic socially wasteful contestability of wealth.

When positioned within this debate, our model places us with Locke and not with Hobbes. In our model, political liberalization results in economic decline, not because of Hobbesian anarchy due to absence of government, but because of the sustained political culture embedded in the norms of behavior of the government that is present.

3. Economic decline in transition

Our model describes a general phenomenon of economic decline, but also in particular suggests an answer to the seeming puzzle of decline in post-socialist societies. In the last decade of the 20th century, socialist societies were given the opportunity to undergo change, and a transition from one system to another began. The puzzle lies in poor economic performance throughout the first decade of transition in the face of the external resources and assistance that were provided (see the extensive country studies in Blejer and Skreb, 2000). The decline often went beyond economic living standards; Ellman (1994) documents the unfortunate accompanying decline in health and life expectancy in some post-socialist societies. The scenario could perhaps have been different. Political liberalization could have brought to the fore principled political candidates and socially beneficial policies, while, at the same time, private foreign capital and domestic economic change, with the assistance provided by international organizations and donor countries, could have provided the foundation for economic progress.

Our model stresses the role of a persisting political culture as the explanation for persistent economic deterioration. Other explanations (see the survey by Matveenko et al., 1998) have looked to the role of initial economic conditions.

---

3 The limitations on individual freedom affect the quality of life, and can affect the continuation of life itself (see Bernholz, 1991).

4 It is also inconsistent with the coercion of majority rule (see Rowley, 1999).

One alternative answer is “disorganization”, or the disruption of traditional supply relationships among the formerly socialist factories (see Blanchard, 1997; Blanchard and Kremer, 1997). Such explanations can be appropriate for explaining outcomes around the point of actual change and informing us why output decline occurred in the early transition. Yet we might suppose, however, that a decade would suffice for initial economic conditions to have declined in significance; for example, a decade might be enough to permit re-organization of intra-factory economic relationships.

A line of argument that addresses the persistence of poor economic performance is that the correct policies were not implemented — which raises the question why this was so, given the extensive policy advice and technical assistance that was provided.6

The norms of a rent-seeking society are reflected in personalized allocation as the prime determinant of individual welfare. In such circumstances, not individual merit, but reciprocal personal favors and convincing others of one’s deserts are principal avenues for personal gain and advancement. It was thus in the nature of pre-transition socialist society that rent seeking was endemic (see Hillman and Schnytzer, 1986).

Cultural norms are an enduring characteristic of a society. Political culture and associated institutions change slowly (see North, 1990). The ways of thinking about the requisites for personal success also, correspondingly, change slowly. As Levin and Satarov (2000) make clear in their study of the Russian case, and as studies of other post-socialist societies confirm (see Blejer and Škreb, 2000), the former social norms and way of thinking about personal advancement remained embedded in the culture throughout the ongoing transition.

We turn now to the exposition of our model of enduring political culture. We shall subsequently return to the world to which the model relates.

4. A model of political insiders and outsiders

In a total population of size $N$, the population is partitioned into $n_1$ insiders and $n_0$ outsiders, so that

$$n_0 + n_1 = N. \tag{1}$$

Insiders are political persons. Outsiders are not. Insiders are positioned to seek personal income and wealth through political assignment, and are for this purpose grouped into associations for collective benefit, or “clubs”.7

---

6 The scope of the policy advice can be seen in the different country economic memoranda published by the World Bank during the 1990s.

7 For an overview of the economic theory of clubs, see Cornes and Sandler (1996).
All persons have active lives of \((T + 1)\) periods. An insider who retires is replaced by an outsider. Outsiders compete for the insider vacancies. An outsider who succeeds in becoming an insider enjoys insider benefits for the remainder of his or her active life.

In the nature of rent seeking, the resources used in the contests among outsiders are expended whether an individual is successful or not in securing a vacant insider position. Each outsider has a unit endowment of potentially productive time,

\[
w_q + v_q = 1, \quad (2)
\]

where \(w_q\) is time spent productively earning income and \(v_q\) is time used in seeking to become an insider.

There are two domains of rent seeking. Insiders directly contest benefits from political allocation, and outsiders expend resources in seeking to change their status to insiders. The equilibrium behavior of insiders and outsiders depends on political culture expressed in government responsiveness to rent seeking and on the institutions that specify how rent-seeking contests are conducted and winners are determined.

### 4.1. Political monopoly

We begin with the institution of political monopoly, with one political ‘‘club’’ of insiders. Members of the single political club or ‘‘party’’ receive benefits that are obtained through the capture of the institutions of the state. The outsiders compete for openings for party membership by choosing allocations in Eq. (2) to maximize lifetime expected utility.

In any period of time, the benefit from being an insider is the difference between insider and outsider utility, and lifetime future benefit at a point in time is the accumulated utility difference over the future period during which an individual is an insider. The outsiders are of different ages. Since the youngest in the population receive the greatest lifetime benefit from party membership, they also have the highest stakes from participation in contests to become insiders.

To describe rent seeking, we require a specification of the contest–success function that designates the identity of a successful rent seeker. For the contests among outsiders seeking insider positions, we adopt a contest–success function that is perfectly discriminating, that is, an outsider who has allocated the most resources to the contest secures the vacant insider position.8

Discriminating contests do not have equilibria in pure strategies. This follows readily, since any outsider who makes a pure-strategy choice of a proportion \(v_q\) of

---

time to allocate to contesting insider membership is defeated by any another outsider who makes a marginally greater outlay. The first contender would then have reason to revise his or her previous decision, either to zero, or to yet a marginally greater outlay than the second contender, who in turn would also have reason to revise his or her initial outlay.

Although no pure-strategy equilibrium exists, mixed-strategy equilibria do exist. Outsiders value success in becoming an insider differently, since individual valuations differ with age of outsiders. In the mixed-strategy equilibria, low-valuation contenders exclude themselves from the contest (see Hillman and Riley, 1989). The actively contesting outsiders who remain maximize expected utility, given by

\[ EU_0 = (1 - t_s)w_0 + \left[ \pi_0 U_1 + (1 - \pi_0)(1 - t_s)w_0 \right]T. \]  

\( T \) here is the remaining productive life of an actively contesting outsider, \( U_1 \) is the per-period utility of an insider, and \( \pi_0 \) is the probability of an outsider becoming an insider. A proportional income tax, \( t_s \) (the subscript \( S \) refers to the state of political monopoly), is levied on the entire population to finance the (net) political allocations to insiders.

The Nash equilibrium solution is for an outsider to choose an outlay less than \( v_0 \) with probability

\[ G(v_0) = \left( \frac{v_0}{U_1} \right) \left( \frac{1}{1 - t_s} \right) \]  

over the support

\[ \left[ 0, T \left( \frac{U_1}{1 - t_s} - 1 \right) \right] \]  

where \( q_s \) is the number of contenders for insider vacancy \( z \).

Consequently, the expected outlay by an actively contesting outsider follows as

\[ EV_O = \frac{T}{q_s} \left( \frac{U_1}{1 - t_s} - 1 \right). \]  

The expected total use of resources by outsiders seeking to become insiders is then

\[ E\Sigma v_O = EV_O = \frac{n_1}{T} q_s EV_O = n_1 \left( \frac{U_1}{1 - t_s} - 1 \right). \]  

\(^9\) We use taxation to describe political redistribution, but the tax is expository. We identify below the types of distribution and political allocation that “taxation” here represents.
Now consider the behavior of insiders. Under political monopoly, insiders expend resources to maintaining outsider subservience. An insider’s resource constraint is
\[ w_i + v_i = 1. \tag{8} \]
Total resources used by insiders to maintain acquiescence or subservience of outsiders are
\[ V_i = \sum_{k=1}^{n_i} v_i = n_i v_i. \tag{9} \]
The resources in Eq. (9) are unproductively used to maintain insider rents.\(^{10}\) We can suppose that the position of insiders is, in addition, more tenable, the less is appropriated from outsiders, that is, the smaller taxation \( t_s \) is.

The resources \( V_i \) and taxation \( t_s \) determine regime viability, through
\[ M = \frac{b}{N} V_i - t_s^2 \geq \bar{M}, \tag{10} \]
where \( \bar{M} \) is the minimum popular discontent that is consistent with viability of the single-party insider regime. The discontent of outsiders increases (we assume at an increasing rate) with appropriation of outsider incomes (expressed in taxation \( t_s \)). \( b \) in Eq. (10) reflects the effectiveness of resource used in countering outsider discontent.

Insiders maximize utility
\[ U_i = \left( 1 - \frac{V_i}{n_i} \right) (1 - t_s) + \left[ \frac{N - EV_O - V_i}{n_i} \right] t_s, \tag{11} \]
subject to the minimum popularity constraint (Eq. 10) and individual resource constraints (Eq. 8). The first term in Eq. (11) is net-of-tax taxable income of insiders (insiders’ taxable income consists of the proceeds of their productive activities, net of the resources per insider contributed to the common cause of containing discontent of outsiders). The second term is the income transfer received by an insider from outsiders: the tax is levied on an economy-wide base of \( [N - EV_O - V_i] \) and the proceeds are distributed among the \( n_i \) insiders. The solution, using Eq. (7), is the equilibrium tax rate\(^{11}\)
\[ t_s = \frac{1 + b}{3} + \sqrt{\left( \frac{1 + b}{3} \right)^2 - \frac{\varphi}{3}}, \tag{12} \]
where \( \varphi = b(n_i/N) + \bar{M}. \)

\(^{10}\) Inefficiency here is reflected in resources not productively used. The same considerations arise with inefficiency due to deadweight losses, which are not present in this model. See also McGuire and Olson (1996) on the efficiency incentives of a ruler as residual claimant.

\(^{11}\) For interior solutions, \( t_s < 1 \), and we therefore assume \( b < 2 \).
The total expected unproductive use of resources in the society is

\[ V_s = EV_o + V_i = NT_s. \]  

(13)

The revenue function for transfers between outsiders and insiders has Laffer-type properties, expressed in:

\[ S_s = (N - V_s)t_s = (1 - t_s)tsN. \]  

(14)

The equilibrium is described in Fig. 1. We express the constraint indicating maximum sustainable political discontent, given in Eq. (10), as

\[ V_i = \frac{N}{\theta} (M + ts). \]  

(15)

The indifference map of insiders between \( V \) and taxation \( t \) can be expressed as:

\[ V_i = NT_s + n_i \left(1 - \frac{U_i}{1 - t_s}\right), \]  

(16)

where \( U_i \) is a constant level of insider utility. The unique equilibrium solution for the tax rate is \( t_s \), which via Eq. (15) specifies insiders’ utility-maximizing allocations \( V_i \) to the collective objective of sustaining the monopoly insider regime.

4.2. Competition for political influence

We now introduce a regime change where competing interest groups, replace the political monopoly. Each of the \( m \) interest groups has equal ex-ante access to influence over political allocation of transfers offered to insiders by the government. Members of interest groups cooperatively contribute personal resources to their collective aim of enriching themselves by influence over political allocation. The utility of an insider in interest group \( j \) is

\[ U_j = (1 - t_c)w_j + \frac{S_c}{n_j}, \]  

(17)

where the subscript \( C \) refers to the regime of competition for influence over political allocation and \( n_j \) denotes the size of interest group \( j \).

\( \rho_j \) in Eq. (17) is the share of government benefits obtained by interest group \( j \). The share is determined by two characteristics of an interest group. A larger size is beneficial politically, because of the greater number of votes that the interest group can offer. The interest group at the same time also benefits from greater resources...
available to influence political allocation decisions. An interest group’s share of lobbying outlays and the relative size of the interest group establish \( \rho_j \) as

\[
\rho_j = \theta \frac{V_j^a}{\sum_{i} V_i^a} + (1 - \theta) \frac{\psi_j}{\sum_{i} \psi_i},
\]

where \( \psi_j = \beta (n_j - \bar{n}) \) and \( \alpha \leq 1 \).

\textsuperscript{12} See Potters et al. (1997) for a model of the ways that votes and political expenditures combine to influence political support.
We obtain the total resources $V_i$ allocated by insiders to seeking political influence by summing over allocations $V_j$ that maximize the utility $U_j$ of a member of interest group $j$. We obtain

$$V_j^* = \frac{\varepsilon S_C}{(1 - t_c)m}, \quad (19)$$

where $\varepsilon = \alpha \theta[(m - 1)/m]$ measures competitiveness of the quest for political influence ($\varepsilon$ is increasing in $\theta, \alpha,$ and $m$, which are all dimensions of political competitiveness). The total resources used by all insiders in all interest groups are

$$V_i = mV_j^* = \frac{\varepsilon S_C}{1 - t_c}, \quad (20)$$

which is increasing in $\varepsilon$.

Interest groups also decide on their size. This decision is made by balancing two consequences of group size. A larger membership provides greater political effectiveness as a constituency to be courted for its votes. A larger membership also gives rise to the need to share politically assigned benefits with more persons. The utility-maximizing number of insiders in an interest group is the solution to $\max_{n_j} U_j(V_j^*)$, which is

$$n_j = \bar{n} = \left\{ \frac{m - \alpha \theta(m - 1)}{(m - 1)(1 - \alpha) \theta + 1} \right\} \hat{n}, \quad (21)$$

where

$$\frac{\partial \bar{n}}{\partial m} < 0, \quad \frac{\partial \bar{n}}{\partial \theta} < 0, \quad \frac{\partial \bar{n}}{\partial \alpha} > 0. \quad (22)$$

That is, interest groups have fewer members, the greater the number of competing groups. The size of an interest group also increases with the political benefit $(1 - \theta)$ of a larger constituency of voters. Interest groups are also larger, the greater the benefit, reflected in the magnitude of $\alpha$, from allocating resources to increase political influence.

Let us now turn to the behavior of the government. Under political monopoly, we described a single insider group as having captured government. Here, $m$ interest groups seek to influence political allocation. The government responds to this competitive rent seeking by choosing redistribution from outsiders to insiders. The government’s budget constraint is

$$\left[(n_0 - EV_0) + (n_1 - V_1)\right]t_c = S_c. \quad (23)$$

Using (Eqs. (7), (17), and (20), and noting that, in equilibrium, $\rho = (1/m)$, the government budget constraint can be expressed as

$$S_c = t_c(1 - t_c)N, \quad (24)$$

which, as Eq. (14), has the form of a Laffer curve.
Under political monopoly, the objective was the minimal acquiescence that maintained subservience of outsiders. Now the government seeks to maximize political popularity. We retain the popularity function of political monopoly. The government under democracy chooses $t_c$ to maximize

$$M = \frac{b}{N} V_t - t_c^2,$$

(25)

where $b$ indicates political sensitivity to rent seeking.

The rate of taxation $t_c$ determines total transfers from outsiders to insiders. From Eq. (20), the government’s objective can be re-expressed as maximization of

$$M = b \xi t_c - t_c^2,$$

(26)

and the chosen tax rate is

$$t_c = \frac{\xi b^{13}}{2}.$$  

(27)

Insiders again retire and outsiders contest the vacancies. Insiders make contributions of resources to the rent seeking activities of their respective interest groups, and the total resources so used by insiders follow from Eqs. (20) and (24) as

$$V_i = \frac{b \xi^2 N}{2}.$$  

(28)

The combined resources used in rent-seeking activities by insiders and outsiders are then from Eq. (13)

$$V_C = E V_0 + V_i = N t_c.$$  

(29)

We are now in a position to compare the resources unproductively used in rent seeking under the two regimes of political monopoly and competition for political influence. We base the comparison on the following assumptions.

A. Maximized popularity achieved by democratic government exceeds the minimum popular support required to maintain the authoritarian regime of political monopoly.

We also require an assumption regarding the location of the economy on its Laffer curve; for this purpose, we assume that taxation has not driven the economy to the revenue-inefficient segment, so that

B. The economy, in regimes of political monopoly and political competition, is situated on the upward sloped segment of the Laffer curve.

---

\textsuperscript{13} Notice that for $b < 2$ (cf. note 11) we have $t_c < 1$. 

To distinguish the regimes of political monopoly and competition for political influence, we require that there be sufficient political competition. Using the measure $\varepsilon$ defined in Eq. (19), we assume

C. There is sufficient competition for political influence.

A, B, and C allow us to conclude that

**Proposition 1.** In the change from political monopoly to competition for political influence, the tax rate increases, total redistribution from outsiders to insiders increases, and the total resources used unproductively in rent seeking by insiders and outsiders increase.

For the proof, see Appendix A. An intuitive explanation for Proposition 1 is as follows. The increased popularity of the government in the regime of competition for political influence is achieved with greater largesse to insiders, whose activities evoke a higher tax rate, and with the economy on the upward sloping segment of the Laffer curve, the outcome is greater redistribution.

Since being an insider is now more attractive, outsiders have a greater incentive to expend resources in seeking to become insiders. The enhanced incentive of an outsider to use resources in seeking to become an insider also reflects the increased unattractiveness of productive activity for outsiders, because of the higher tax rate on income from productive activity. That is, outsiders confront a substitution effect on resource allocation.

Insiders and outsiders thus expend more resources in unproductive rent-seeking activities, and, as Proposition 1 states, real output in the economy declines.

**4.3. The end of insider privilege**

After the above liberalization from political monopoly, the population has remained divided between insiders and outsiders. Further liberalization in access to political influence can end the insider–outsider distinction, and permit everybody to join one of the $m$ interest groups.

If there are no longer outsiders and insiders, no resources are expended in seeking to change status from outsider to insider. However, with the political culture of rent seeking retained, government remains responsive to private quests for political favors, and the incentive remains for interest groups to seek to influence political allocation (which is the raison d’être for the continued existence of the interest groups). Individuals continue to contribute personal resources to their respective interest groups. Everyone thereby participates in direct political activity through an interest group association.

The government again chooses a rate of taxation to maximize political popularity, and the revenue is distributed among the interest groups. The government’s budget constraint is (the subscript $L$ refers to the further political liberalization)

$$w_L N = S_L.$$ (30)
From Eq. (20), per-capita income in the economy derived from productive activity is

\[ w = 1 - \frac{V_1}{N} = 1 - \frac{\varepsilon S_L}{(1 - \tau_L)N}. \]  

(31)

Substituting Eq. (31) into Eq. (30) yields the total value of government transfers available for distribution as

\[ S_L = \frac{\tau_L(1 - \tau_L)N}{1 - (1 - \varepsilon)\tau_L}. \]  

(32)

and using Eq. (20) again, the total value of resources unproductively used in rent-seeking activities in the economy is

\[ V_L = \frac{\varepsilon \tau_L N}{1 - (1 - \varepsilon)\tau_L}. \]  

(33)

When we evaluate \( V_L \), at interior solutions for the tax rate \( \tau_L \), we conclude that

**Proposition 2.** Liberalization of access to political influence that ends insider privilege increases the tax rate. With sufficient competition for political influence (\( \varepsilon \) sufficiently high) and with bounded sensitivity of government popularity to insider rent seeking, total redistribution increases, and total unproductive use of resources in rent seeking increases.\(^{14}\)

The proof is in Appendix B. To understand Proposition 2, we begin with the observation that the end of privileged exclusivity of insiders in seeking politically assigned benefits has increased the number of members in each of the \( m \) interest groups. This does not change an interest group’s equilibrium total political outlays for a given aggregate rent-seeking prize \( S \) that is to be shared among the interest groups.\(^{15}\) When the tax rate increases, political support declines (taxes per se are unpopular). The increased taxes also increase the value of the political prizes available to the (now non-exclusive) interest groups, which increases political popularity, and by more so than the popularity lost by the tax increase (otherwise in the new equilibrium, the tax rate would not have been increased). In a regime of political insiders and outsiders, increasing the tax rate from the equilibrium value would lead outsiders to increase their efforts to become insiders, so reducing the tax base, which is composed of income that has been earned from productive activity. This disincentive for government to increase the tax rate is no longer present, since there are now no outsiders — and in the new regime the tax rate consequently increases.

\(^{14}\) The parameter \( b \) can assume values such that \( S_L > S_c \) and \( V_L > V_c \).

\(^{15}\) This is so, since in contests where the prize is shared and where total outlays are cooperatively determined, the total resources used by members of an interest group to influence political allocation depend only on the value of the prize, and are independent of the size of the interest group (see Eq. 19).
The increase in the value $S$ of the total prize offered for redistribution can be seen to depend upon the weight $b$ of rent seeking in the political-popularity function. A larger value of $b$ encourages use of resources in rent seeking and so reduces the tax base of income from productive activity from which $S$ is obtained. Therefore, if $S$ is to increase, $b$ cannot be too large. Nor can $b$ too small, for then there is, in the limit, no point to rent seeking.

Proposition 2 describes the outcome of a negative-sum rent-seeking game for society at large (see also Tullock, 1980b). Rent-seeking prizes are financed by the entire population, which dissipates resources in competing for a share of the politically assigned prizes. All members of society are therefore placed in a prisoners’ dilemma. Everybody would have a higher expected utility if, in the function describing the behavior of government, $b$ was equal to zero, that is, if government was unresponsive to rent seeking. $M$ would then be maximized by $t_L$ equal to zero, and the aggregate rent-seeking prize $S$ would be zero.

When the population is divided into political insiders and outsiders, the privileged insiders have a self-interest in perpetuating the political culture that maintains $b$ positive. When everyone is free to join an interest group, the political culture is mutually disadvantageous for the entire population.

4.4. Free entry of interest-group coalitions into contests for political favor

A further step in liberalization of competition for political influence allows any group of individuals to form a coalition to approach the government to seek politically assigned benefits. The number of interest groups $m$ is then no longer fixed but variable. The consequence of this next step in liberalization in influence over government is

**Proposition 3.** Beginning from the equilibrium of Proposition 2, let individuals be free to form new interest groups. Let the number of competing interest groups as a consequence increase. Total resources used unproductively in rent seeking then increase, and real income in the economy declines further, provided that there is sufficient political competition (i.e., that $\varepsilon$ is sufficiently high), and that $b$ is not too large.\(^{16}\)

The proof is in Appendix C. Proposition 3 reflects the increased competition among the greater number of interest groups. Again, society is engaged in a negative-sum game, with now greater real losses because of greater competition in rent seeking, and everyone in society would gain from the end of the political culture of rent seeking.

\(^{16}\) Again, if $b$ is too large, the incentives to use resources in rent seeking erodes the tax base, and there is little or nothing to transfer. Hence the proposition requires that $b$ not be excessively large.
5. Bribery and corruption

A question that we can now raise is: why, after the end of political monopoly, is \( b \) still positive? That is, since the positive weight on political response to rent seeking underlies economic decline, why is government responsive to the unproductive rent seeking of private agents?

One interpretation of \( b > 0 \), consistent with political competition in more mature democracies, is that interest groups provide “political support”. 17 In these circumstances, the resources used in rent seeking take the form of time spent gaining political access to state a case, and then the time and resources used to promote the electoral success of preferred candidates. The quotations at the beginning of this paper, and other indications, suggest however that money rather than real resources is used to seek favorable political allocation in post-socialist economies. 18 Monetary bribes are not in themselves a source of social loss, since money changing hands does not in itself mean that real resources are wastefully employed.

Our model has not identified the people in government who would receive any such monetary bribes. Government has been placed outside of the population of \( N \) insiders and outsiders. With persons in government outside the population, bribery requires no amendment to the conclusions. This is so, since the value of real resources available for consumption by the \( N \) insiders and outsiders is independent of whether \( V_1 \) is lost in the form of resources directly dissipated in rent seeking, or whether \( V_1 \) is an external monetary transfer used for real consumption outside the population (and perhaps outside the country).

A simple amendment to the model places persons in government within the population of \( N \) and introduces another domain of rent seeking. The new contests are for the monetary transfers received by political decision-makers. Social loss is then re-computed within the extended hierarchy of rent-seeking contests. 19 For example, let \( b \) be the share of \( V_1 \) that is a personal monetary transfer to persons in government: \( b V_1 \) is then the prize in rent-seeking contests to become these persons. In the now three-tiered hierarchy of contests, (1) outsiders are seeking to become insiders, (2) insiders are seeking to influence political allocation decisions, and (3) individuals are at the same time seeking to achieve positions in government to which bribes \( b V_1 \) accrue.

Corruption of persons in government in accepting monetary bribes thus adds a third stage to rent dissipation. In discriminating contests, the value of the bribes is

---

17 In representative democracy, interest groups can be expected to have political weight that belies the numbers of their members (see for example Sandler, 1992).
18 See McChesney (1997) on political rent extraction. Ursprung (1990) describes political competition where candidates for elected office personally keep for themselves some part of the campaign contributions they receive.
19 For an exposition of rent seeking within a hierarchy of beneficiaries who benefit from lower echelon corruption, see Hillman and Katz (1987).
6. Realities of decline and collapse

As we have observed, and as predicted by our model, political liberalization in post-socialist economies was accompanied, in different instances and degrees, by economic decline. The Ukraine experienced ongoing economic deterioration within a political culture of rent seeking (see Kaufman, 1997; Åslund, 2000). In Belarus, economic decline culminated in retrogression to an illiberal regime (see Nuti, 2000). Collapse occurred in 1997 in Bulgaria and in Albania (on Bulgaria, see Koford, 2000; on Albania see Muço, 1998, who describes insider–outsider transfers that took place through Albanian pyramid investment schemes, with apparent state mediation). In Russia, the institutions of government were used to bestow privileged political favors on insiders (see Levin and Satarov, 2000) and economic collapse occurred in the summer of 1998 (when the government defaulted on domestic-currency denominated bonds).

Not all the stages of political liberalization described in the model were attained when collapse took place. In general, at the time of collapse, the insider–outsider distinction remained present.

The contestability of wealth has often taken place in an interface, which we have not modeled, between criminal activity and political allocation. The occupations most dangerous to life in Russia have been those of banker, businessman, and politician (see Kisunko, 1996). Under these conditions, the social costs of extortion (see Konrad and Skaperdas, 1998) and organized criminal activity (see Fiorentini and Peltzman, 1996) complement the social losses due to rent seeking.

In considering the relation of our model to observed behavior, it is also important to note that our concept of “taxation” is symbolically representative of means of redistribution and rent assignment, and is not taxation as understood as the collection of government revenue for disbursement. Tax-revenue collection was lax in Russia and in other transition economies.

---

20 The International Herald Tribune reported on November 26, 1998 (Thanksgiving): “Amid severe food shortages, the Belarus government is imposing rationing for milk, meat, matches, and other goods. Officials in the capital, Minsk, have limited shoppers to 2 cartons of milk, 2 kg (4.4 lb) of meat or poultry, 400 g (11 oz) of cheese, 10 boxes of matches, and 300 g of chocolate.” Such rationing is of course reminiscent of Soviet times.

21 Since taxes are public income, the prediction, from a rent-seeking perspective, is that where possible, taxes will be converted to private income. Consistently, in Russia the interest rate on tax arrears has been less than the market bank rate of interest, and tax liability has been incurred only when monetary payment has been received for goods and services rendered, under conditions where (as a consequence) the majority of transactions take place by barter (see Conrad, 1998).
The list of means of rent assignment and redistribution represented by “taxation” in the model is extensive. The list can begin with exclusive privileged private transactions with non-privatized state factories, which create private rents by permitting sale of inputs and purchase of outputs at arbitrary prices. When privatization takes place, insiders purchase state assets at privileged prices or secure privileged allotments of stock. When workers receive stock allocations, insiders secure the stock from workers at preferential prices. Insiders who control share registries allocate stock to themselves and annul ownership of others. Privileged export quotas are assigned in combination with domestic price subsidization, and foreign-imposed export quotas are likewise assigned by privilege. Exclusive import rights are assigned. Taxes are withheld or are simply not paid, not as surreptitious tax evasion but as privileged (although formally de jure illegal) dispensation. Privileged private banks service the government. Directed subsidies and credits are provided from state banks or from the central bank for the benefit of private agents. Insider-information about impending devaluations permits foreign exchange reserves, including funds made available from international-agency assistance, to be “privatized” for personal gain.

These mechanisms for insider benefit require active participation by government as the patron and designator of privilege. Privileged distribution also takes place in consequence of state passivity (or using the terminology of Abel and Bonin, 1994, by “state desertion”). Assets of banks (depositors’ savings) are illegally appropriated because of absent or inadequate regulation. Payments for fictitious imports are made through false invoicing, and taxes are evaded by retention abroad of export proceeds. Where the state has remained a shareholder in the exporting firm, revenue due to the state is appropriated. Insiders are permitted to decapitalize state firms. Large-scale smuggling is condoned. Or there is state passivity (or state complicity) in the face of pyramid “investment” schemes offered to a naive public.22

7. The economic structure

We have emphasized political allocation as the source of private benefit;23 economic activity in our model has been described through individual time- allocation decisions. More elaborate descriptions of economic structure are consistent with our model of political allocation. Nekipelov (1998) observes that the market infrastructure of Russia during the first decade of transition should be viewed as

22 On these mechanisms of insider benefit, see also Gelb et al. (1996, 1998).
23 Our focus on rents has downplayed market incomes. Brainerd (1998) reports on market income disparities between “winners” and “losers” during the Russian transition. The inequalities are made wider by the politically assigned insider rents that are not reported in official market statistics and household survey data.
“little more than Potemkin’s village”. Gaddy and Ickes (1998) elaborate on Nekipelov’s theme, and describe an economy that consists of a natural-resource sector that has positive value-added and a manufacturing sector that destroys value. The negative value-added manufacturing sector is a means of internal distribution that provides employment and income for the general population. The political insiders who contest and claim the natural-resource wealth accept the transfer mechanism as necessary for preserving outsider acquiescence and social stability. As is the case with the political culture, the economic structure of negative-value-added manufacturing is a carry-over from the prior industrial system that was sustained by subsidized (below world-price) inputs.

8. Solutions

It is natural to contemplate solutions. A direction that a solution can take is constitutional restraint to bound political discretion. A constitutional solution may however offer little promise of change for contemporary generations. The constitution that is sought will require detachment in time, so as to permit future social altruism to overcome contemporary personal and political self-interest (see Buchanan, 1975). A constitutional solution thus requires a population with patience.

An attempt can also be made to change behavioral norms through education (see Guttman et al., 1992). Personal example of the leadership offers another direction. One can hope for spontaneous national moral revival (see Grossman and Kim, 2000).

We can observe that some of the prizes for rent seeking have been supplied by international agencies seeking to preserve “stability” in the post-socialist society. Rent-seeking behavior may be abated if rent-seeking prizes are restrained.

As a concluding remark, we note that our model has portrayed all outsiders as wishing to become insiders. We require however only that the insider vacancies are contestable. This is compatible with the personal choice that people make to remain political outsiders, and recognizes that many people in the population of outsiders find participation in contests to become political insiders ethically distasteful. Outsiders can contemplate other responses. If they are geographically concentrated, they might attempt to escape by secession (see Buchanan and Faith, 1987), or they might seek to escape by emigration (on emigration of outsiders, see Epstein et al., 1999). They might also seek to resist by civil disobedience (see Grossman and Kim, 1995; Falkinger 1999).

---

24 The monetary value of manufacturing output is artificially inflated by declarations of value that are not put to the test of market valuation; barter is prominent and monetary exchange is not, because barter sustains the artificially inflated declarations of value.

25 See Grossman (1995) for a model with such voluntary redistribution incentives.

26 See also Buchanan (1993) on attributes of the constitution.
Acknowledgements

In revising this paper, we have benefited from the helpful insights of Martin McGuire. We have also benefited from the comments of participants at the Conference on Financial Instability and Longer-Term Prospects for Economic Transformation in Russia, sponsored by the Education and Research Consortium, Moscow, in December 1998, and the Conference on Political Culture, Economic Policy, and Economic Performance, at the Tinbergen Institute, Erasmus University, Rotterdam, in February 1999. We acknowledge the support of the Max Planck Prize in undertaking this joint research.

Appendix A. Proof of Proposition 1

The tax rates $t_\theta$ and $t_C$ are determined in Eqs. (12) and (27), respectively. Since $t_C$ is an increasing function of $\varepsilon$, $t_C$ can only exceed $t_\theta$ if the condition $t_C(\varepsilon = 1) > t_\theta$ is satisfied, and does so for $\varepsilon$ sufficiently close to unity. Using Eqs. (12) and (27) we arrive at

$$t_C(\varepsilon = 1) > t_\theta \iff \frac{n_0}{N} + \frac{\hat{M}}{b} < \frac{15}{4}.$$  \hfill (A1)

The equilibrium level of political support $M_C$ in regime $C$ is given by (see Eqs. (25), (27) and (28))

$$M_C = \frac{b\varepsilon^2}{4}.$$  \hfill (A2)

For $M < M_C$, we thus have

$$\frac{\hat{M}}{b} < \frac{b\varepsilon^2}{4}$$  \hfill (A3)

and since $b < 2$ (see note 11), condition (A1) is satisfied

$$\frac{n_0}{N} + \frac{\hat{M}}{b} < \frac{n_0}{N} + \frac{b\varepsilon^2}{4} < \frac{15}{4} < \frac{15}{4}.$$  \hfill (A4)

Comparing rent-dissipation under the two regimes with the help of Eqs. (13) and (29) immediately yields

$$t_C < t_\theta \implies V_C < V_\theta.$$  \hfill (A5)

The relationship between the size of the state sector as defined by $S$ and the tax rate (see Eqs. (14) and (24) for the regimes $S$ and $C$, respectively) represents a Laffer curve with a maximum at $t = 1/2$

$$S_K = t_K(1 - t_K)N, \quad K = S,C.$$  \hfill (A6)
Thus, as long as $t_c < 1/2$, i.e. as long as we are on the upward-sloping side of the Laffer curve (Eq. (A6)) we have

$$t_c > t_s \iff S_C > S_s$$

(A7)

which completes the proof.

Appendix B. Proof of Proposition 2

Substituting Eq. (33) in Eq. (25) yields

$$M_L = be \frac{t_L}{1 - (1 - \varepsilon)t_L} - t_L^2.$$  \hspace{1cm} (A8)

Comparing this expression with Eq. (26), we arrive at the common government objective function for the regimes C and L

$$M_K = be \frac{t_K}{1 - (1 - \delta \varepsilon)t_K} - t_K^2,$$

where $\delta = \begin{cases} 1, & \text{for } K = L \\ 1/\varepsilon, & \text{for } K = C. \end{cases}$  \hspace{1cm} (A9)

Since we envisage interior solutions of $t_L$, we derive the first-order condition for political-support maximization

$$\frac{\partial M_K}{\partial t_K} = \frac{e}{1 - (1 - \delta \varepsilon)t_K} - 2t_K = 0$$

(A10)

and apply the implicit function rule to obtain

$$\frac{\partial t_K}{\partial \delta} = \frac{e^2 b t_K}{\left[1 - (1 - \delta \varepsilon)t_K\right]^3} \frac{\partial^2 M}{\partial t_K^2}$$

(A11)

which is negative given that the second-order condition of political-support maximization is satisfied. A regime change from C to L is associated with a decrease in $\delta$ from $1/\varepsilon > 1$ to 1. We thus have $t_L > t_c$.

To compare $S_L$ with $S_C$ we use Eqs. (24) and (27) to arrive at

$$\frac{dS_L}{d\varepsilon} = \frac{bN}{2}(1 - be).$$  \hspace{1cm} (A12)

Differentiating $S_L$ with respect to $\varepsilon$ yields

$$\frac{dS_L}{d\varepsilon} = \frac{\delta S_L}{\delta \varepsilon} + \frac{\partial S_L}{\partial t_L} \frac{\partial t_L}{\partial \varepsilon}$$

(A13)

and using Eqs. (32) and (A10) to compute the partial derivatives we obtain

$$\frac{dS_L}{d\varepsilon} = -\frac{t_L^2(1-t_L)N}{Z^2} + \frac{bN}{Z^2}(1 - 2t_L + (1 - \varepsilon)t_L^2) \frac{(1 + \varepsilon)t_L - 1}{2e(1 - \varepsilon)b - 2Z^2},$$

(A14)
where \( Z = 1 - (1 - \varepsilon) t_L \). At \( \varepsilon = 1 \) we have \( t_L = t_C = b/2 \) since the first-order condition in Eq. (A10) coincides for the two regimes. Thus,

\[
\frac{dS_L}{d\varepsilon} (\varepsilon = 1) = \frac{bN}{8} (4 - 10b + 5b^2). \tag{A15}
\]

Combining Eqs. (A12) and (A15), we arrive at

\[
\frac{dS_C}{d\varepsilon} (\varepsilon = 1) - \frac{dS_L}{d\varepsilon} (\varepsilon = 1) = \frac{b^2N}{8} (6 - 5b) > 0 \iff b < 6/5. \tag{A16}
\]

For \( b < 6/5 \) and \( \varepsilon \) sufficiently close to unity we thus obtain \( S_L > S_C \) since \( S_L(\varepsilon = 1) = S_C(\varepsilon = 1) \).

To compare the extent of rent dissipation under the two regimes, we proceed just as above and compute, using Eqs. (27) and (29),

\[
\frac{dV_L}{d\varepsilon} = \frac{bN}{2}. \tag{A17}
\]

We then use Eqs. (33) and (A10) to compute the expression

\[
\frac{dV_L}{d\varepsilon} = \frac{\partial V_L}{\partial \varepsilon} + \frac{\partial V_L}{\partial t_L} \cdot \frac{\partial t_L}{\partial \varepsilon}
\]

and arrive at

\[
\frac{dV_L}{d\varepsilon} = t_L(1 - t_L)N \frac{eN}{Z^2} \left[ (1 + \varepsilon)t_L - 1 \right] b + \frac{eN}{Z^2} \frac{2 e (1 - \varepsilon) b}{2 e (1 - \varepsilon) b - 2 Z^2}. \tag{A19}
\]

At \( \varepsilon = 1 \), we again have \( t_L = t_C = b/2 \) and thus obtain

\[
\frac{dV_L}{d\varepsilon} (\varepsilon = 1) = \frac{bN}{2} \left( 2 - \frac{3 b}{2} \right). \tag{A20}
\]

Comparing Eq. (A17) with Eq. (A20), we arrive at

\[
\frac{dV_L}{d\varepsilon} (\varepsilon = 1) < \frac{dV_C}{d\varepsilon} \iff b > \frac{2}{3}. \tag{A21}
\]

For \( b > 2/3 \) and \( \varepsilon \) sufficiently close to unity we thus obtain \( V_L > V_C \) and the proof is complete.

Appendix C. Proof of Proposition 3

Since the number of interest groups \( m \) appears only in the parameter \( \varepsilon \), we consider the consequences of an increase in political competitiveness
\[ e = \alpha \theta (m - 1)/m. \]

Assuming again an interior equilibrium \( t_L \in (0, 1) \), the first-order condition (Eq. A10) is satisfied and we obtain

\[ \frac{dL}{d\varepsilon} = \left[ (1 + \varepsilon) t_L - 1 \right] \frac{b}{2} \frac{(1 - \varepsilon) b - 2Z^3}{(1 - \varepsilon) b - 2Z^3}. \]  

(A22)

At \( \varepsilon = 1 \), using \( t_L(\varepsilon = 1) = b/2 \), we have \( \frac{dL}{d\varepsilon}(\varepsilon = 1) = b(1 - b)/2 \) for \( b < 1 \) and thus \( \frac{dL}{dm} > 0 \) for \( \varepsilon \) close to unity and \( b < 1 \).

Turning, finally, to rent dissipation, we see immediately from Eq. (A20) that

\[ \frac{dV_L}{d\varepsilon}(\varepsilon = 1) = \frac{bN}{2} \left( 2 - \frac{2}{3} \frac{b}{b} \right) > 0 \iff b < \frac{4}{3}. \]  

(A23)

Thus, for \( b < 4/3 \) and \( \varepsilon \) sufficiently close to unity, \( dV_L/dm > 0 \), which completes the proof.

References


background paper, the World Bank, Washington, DC, revised as Rents as distractions: why the exit
from transition is prolonged, In Baltas, N.C., Demopoulos, G., Hassid, J. (Eds.), 1998. Economic
Economy 11, 399–410.
Grossman, H.I., Kim, M., 1995. Swords or plowshares: a theory of security to the claims to property.
Political Economy 16, 173–187, This issue.
Economics and Politics 4, 31–42.
of Corruption and Illegal Markets. Edward Elgar, Cheltenham.
Economy 16.
growth in Russia, EER Consortium Moscow, Russian Economics Research Program, working paper, 98-03.
McGuire, M.C., Olson, M., 1996. The economics of autocracy and majority rule: the invisible hand and
the use of force. Journal of Economic Literature 34, 72–96.
New York.
endorsements: the strategic use of information and money to influence voter behavior. European


