

Rent-Seeking, Hierarchy and the Centralization: Why the Soviet Union Collapsed So Fast and What it Means for Market Economies

Opening of the archives confirmed that the Soviet Union was a hierarchical economy driven by planning, not a rent-seeking society. Rent-seeking was not possible in the classical socialist society because lower level officials could not trust their superiors to collaborate. Individual incentives would have favored rent-seeking in the absence of punishment, therefore loosening of control during perestroika infused the system with rent-seeking and triggered the collapse of the planned economy. Rent-seeking drives decentralization of a hierarchical economy but centralization of a free economy, suggesting a tipping point between the two systems.

Background

Traditional accounts (Krylov 1979, Kornai 1980, 1986, Nove 1986) describe shortages in the socialist economy as endemic to national economic planning. Janos Kornai (1980) argues that the soft budget constraint creates infinite demand in a supply constrained economy, and paternalism and control create a culture that allows the hierarchical system to dominate. Joseph Berliner (1957) points to the “safety factor,” or hoarding, as a cause of shortage. In general, scholars of the Soviet economy find evidence of coordination problems between plan elements, and point to them as a primary reason for shortage and poverty.

Recently, some economists (Boettke 1993, Anderson and Boettke 1997, Shleifer and Vishny 1992) questioned these descriptions and modeled the Soviet system as a rent-seeking economy not different in kind from a market system, although more heavily regulated. According to these models, shortages result from rent-seeking activity. Managers of Soviet enterprises lobby ministers for lower prices or lower output in order to obtain side-payments for goods in shortage.

However, the rent-seeking models depend upon a decentralization of supply and price choices that did not exist in the Soviet Union. Recent studies by Lazarev and Gregory (2002), Gregory (2002) and Harrison (2002), which make use of newly available archival material, confirm what Sovietologists had long depicted. Firm managers in the Soviet economy actually lobbied for higher, not lower, prices. Rent-seeking not only did not exist but also could not exist in the classical socialist society. However, there was a good reason that those economists mistakenly believed what they did: the Soviet Union was in fact collapsing into a rent-seeking economy at the time that they wrote.

Although the rent-seeking models miss the mark in describing classical socialism, they may help to illuminate the collapse of the Soviet system, and the tipping point between market and socialist systems. Models showing how the incentive structure was conducive to rent-seeking in the hierarchical socialist society are important. These models, taken together with an understanding of why rent-seeking was in fact not possible in the command economy, can help to explain how the Soviet economy collapsed so fast and why the Russian economy has taken the form it takes now.

Rent-seeking decentralizes a command economy, though it drives a market economy toward a more centralized allocation of resources. This is an important dynamic of interventionism, and can help to shed light on transition economies, mixed economic systems and development economics.

The Nature of the Soviet Economy

Peter Boettke (2001) argues that the Soviet economy was never a planned economy. It not only could not live up to its Utopian ideal, but in fact, it never achieved any form of true planning, but instead languished as a rent-seeking, highly interventionist *market* economy.

Boettke argues that while socialism was initially intended to be a rationally planned economic system, not only the rationality but also the planning of the economy was an illusion. To buttress this characterization, Boettke argues that planners could not control the economy because they could not rationally allocate resources. Without prices or local knowledge and using only aggregate economic

indicators, rational planning was impossible.

The underlying insight regarding economic calculation in a socialist society is accurate¹. Planners could not know how best to allocate resources without a market in which demand, costs and local conditions could be discerned. However, this does not mean that they could not *drive* the economy, just not consciously or to their intentions.

Planners can control the economy blindly. The driver is not directing a car that is being thrown about by hurricane force winds, even if the winds are not consciously choosing the direction the car goes. Similarly, decentralized forces did not drive the Soviet economy, even though its direction was out of the control of the planner's conscious intentions. This is different in kind from a market economy, which is controlled by the consumer, or a rent-seeking economy driven by those seeking rents.

Constantin Krylov (1979) argues that, “[the] planned price-setting procedure is the basic cause of general disproportions in the national economy.” Although he writes in no way sympathetic to the feasibility of *rational* planning, he maintains that planning was the major force in the Soviet economy:

The plan created by national economic planning is the primary instrument that puts the Soviet economy into motion in all of its operations and manifestations. The internal peculiarities of the plan determine everything in a decisive manner. (p. 37)

In this view, the hierarchy of the economy and the commands of the planner, even if irrational, are the “driving force” of the economy, the force that sets the economy in motion and determines production and allocation.

Some (Zaleski 1980, Wilhelm 1985) have argued that the Soviet Union was a “managed” or “administered” economy, not a planned economy. Allocation at the lower levels was less centralized, and plans were often revised based on reports from lower level officials. However, lower level officials

¹ See, for example, Mises (1922; 1949), Hayek (1945) and Hoff (1949), for theoretical arguments, and Nove (1986) and Krylov (1979) for supporting evidence of socialism in practice.

had only two powers in this regard. One was to negotiate with their superiors in order to temper the harsher conditions of the taut plan presented, the other was to hide information from them so that their plan might be less harsh. Both of these constitute behaviors that higher level officials would predict, and do not change the nature of the system. It is in the nature of a command economy that lower level officials will try to bargain for lower output and higher input levels and hide any information that reveals their true capabilities. It is also in the nature of a command economy that agents in principal-agent relations will tend to shirk and to steal. Together, these constitute “the fundamental problem of command” (Harrison 2008).

The Extent of Markets within Socialism

Boettke describes the widespread markets in the Soviet economy, including *tolkachi* middlemen (2001: p. 148). *Tolkachi*, literally meaning “pushers,” were those employees of Soviet firms who were sent by the manager of the firm to pressure the supplier to fulfill the supply order, to ensure that the enterprise could reach its plan targets (Berliner 1957). Although *tolkachi* engaged in trading, they did so in order that state enterprises could fulfill their plan targets. Hence, the origin of this activity is the plan – not the entrepreneurial drive of these intermediaries.

The products that they had to trade and sell were those that planners had commanded them to make. Demand for those goods was also determined by planners’ targets. The prices or exchange values of those goods were those emerging from state planned supply and state planned demand. The implicit legality of that market was due to this fact; planners recognized that *tolkachi* trading was the grease for the creaky machinery of Soviet planned industrial development. Far from being free markets, the *tolkachi* trading was just one state monopoly exchanging state goods with other state monopolies, in order to fulfill state commands.

State economists and Marxists debated this question. Ota Sik asked the theoretical question of whether, according to Marxist theory, all exchange could cease before the arrival of pure communism.

The question rested on whether socialist exchange – that exchange between purely socialist firms – was the same in kind to commodity exchange. A few schools of thought emerged during the socialist experiment. Stalin argued that it was different in kind, while the left argued that all commodity exchange must eventually cease altogether (Sik 1967).

While Stalin's argument may have been based in expediency, it is surely true that bartering and exchange between two government entities with fixed output and fixed input requirements is hardly the kind of market exchange that can drive the economy. Furthermore as government entities, their budgets are soft (Kornai 1985), so the price they are willing to pay in the exchange is purely based on the input requirements set for them externally², uninfluenced by any consideration of minimizing costs. These firms cannot even be assumed to have downward sloping demand curves. In fact, Nove documents upward sloping demand curves for inputs by socialist firms, when purchased legally, in order that they may increase the costs that they can report (1986: p. 179).

Although black and gray markets played an important role in the Soviet Union because they increased the welfare of the citizens, it was a subordinate role in terms of the nature of the economy. These markets did not drive production; they lived beneath the surface. As Berliner (1957) put it, “The penumbral world of informal inter-enterprise relations represents the severely harnessed rudiments of a market economy seeking to break through the hard crust of centralized planning.”

Rent-Seeking Within Socialism

Boettke (2001) and Shleifer and Vishny (1992) argue that managers and ministers colluded to produce shortages. They describe the Soviet Union as a rent-seeking economy in which decentralized pursuit of rents drove the production and allocation of resources. According to their model, managers asked ministers to collaborate to induce shortages of the goods they produced in order that they could

² To some extent, budgets were a constraint, especially on lower-priority firms, because planners provided different accounts to firms for different kinds of purchases. However, price was still not the primary consideration in purchases, because allocation orders were required for each purchase and this consideration tended to dominate. If an allocation order could be acquired, the cost would be covered by the state regardless of the price demanded (Berliner (1957)).

extract side-payments from consumers. These side-payments were then shared with the ministers.

Planners set targets for firms as part of the command ordering of the economy. Boettke (2001: p. 145-6) and Shleifer and Vishny (1992) argue that targets were maximums, similar to output restrictions by a cartel. However, the evidence is to the contrary. Nove (1986) and Berliner (1957) document the “ratcheting” of targets for firms each plan period. When firms successfully fill their plan, the planned output for that firm is increased for the next period. If a firm exceeded the planned output, the new plan would incorporate the actual level of output the firm achieved, and ratchet it up from there. This would be odd behavior if the minister wanted to keep planned output low.

Abundant evidence suggests that ministers were attempting to raise output by firms under their watch, not reduce it. In addition to ratcheting the output up each plan period, when reforms were put in place that encouraged firms to provide “counterplans” of higher output levels, ministerial officials commonly seized upon them as evidence that the enterprise in question could produce at a higher level, and increased their target output level on that basis (Nove 1986: 101). Ministers had their own output plans to fill. Driven by these plans, ministers set “premiums” for management of the enterprises in their ministry according to the most important products for the ministry plan (Berliner, 1957). As part of the hierarchy of planning, ministers and managers alike were driven by the targets and rewards set from above. Based on interviews with former Soviet firm managers, Berliner (1957: 23) sums up the “massive fact” about the life of the Soviet firm manager as the “sense of pressure from above” which took the form of “an incessant demand for more and more production.”

There is no question that there was lobbying by “interest groups,” both managers and ministers, in the form of asking for lower output targets or higher input quotas. However, this was Niskanen-style budget maximizing, not the rent-seeking of Boettke or Shleifer and Vishny. These bureaucrats were not lobbying for a change in the real price of their product in order to obtain side payments in the form of bribes or black market sales, but were simply trying to reduce their burdens and ensure their success within the plan hierarchy. There is evidence that managers of firms actually “lobbied” for higher prices

(Sik 1967, Krylov 1979, Kornai 1980, Nove 1986, Gregory and Harrison 2005) and also used “new products” with inflated prices to get around low fixed prices (Berliner 1957, Harrison 1998). They did this by reporting higher input costs (or obtaining costlier inputs), which they knew would lead planners to set higher prices, because higher prices would help them to fulfill their plan.

There are further reasons why a low priced input, even if socialist firms were not trying to inflate costs, might not lead to shortage. In the socialist economy, even if it were driven by rent-seeking, supply would not be reduced by lowering the price, because supply was determined by the plan. Only demand would be free to respond. Yet, demand by firms would not necessarily respond to lower price because they had soft budget constraints and were restricted by the need for allocation orders³ even when going through *tolkachi* (Berliner 1957).

There was also rationing of some goods in the consumer market. A lower price alone might not drive up demand, because price was not the only consideration. As the saying used to go: a rouble is just a piece of paper, which, with enough other documentation, allows you to buy something. Finally, if bribery became ubiquitous, a lower official price would not increase demand, because the cost of the bribe would become built in. In this case, even if the lower official price would mean more bribe money it could not induce a shortage.

Shortages can be explained by planning errors and the fear of input shortages resulting from them, which, combined with the soft budget constraint, results in hoarding. This, in turn, exacerbates shortage. Plan errors and shortages are further irritated by incentives that pressure firm managers to alter the assortment of goods produced, overfulfilling output plans for some goods at the expense of others (Berliner 1957). The lack of the holistic measure of profit as motive, and the use of a hodge-podge of targets and premiums in its place, leads to more shortages and low-quality output, reinforcing

³ Berliner (1957: 22), on the basis of interviews as well as published materials, makes the case that “The allocation order is one of the most crucial documents in the life of the firm,” and “much of the activity of the management focuses on this document.”

the impression that in order to fill ones own plan hoarding is necessary⁴. Unused resources waste away in warehouses of firms, managers scared that they would need them to fulfill next month's plan, or unable to use them due to a lack of complimentary production goods. A process such as this is described in both Kornai (1980; 1986) and Berliner (1957).

The shortage of consumer goods was also due in part to priorities. Military production was the top priority, industrial investment was next, and consumer goods lagged far behind⁵. Firms that also supplied production and intermediate goods underfulfilled the already low plan levels because premiums offered for consumer goods were relatively low. Higher consumer goods prices were offered to try to induce firms to produce them, and these were helpful for reaching “planned profit” targets, but the incentive to produce consumer goods was still low (Berliner 1957: 129)⁶.

The bribes and black and gray markets came about as a *result* of the shortages, according to this view; they did not drive them. The second economy for consumer goods was well known. There was evidence of a strong second economy for housing (Alexeev 1988). There are other cases of corruption, black markets, and of other mechanisms that deviate from the plan. Yet these may not have been the cause of shortage, but simple opportunism.

If the plan guided the economy, this need not imply benevolence or rationality. A hierarchical system with a plan as the outer shell and opportunism within still entrenches the leaders, prevents reform, and involves opportunism and corruption, but it also produces paternalism, the inability for workers to respond to incentives, the sluggish social environment, idolizing of leaders, the waste of the soft budget constraint and other characteristics we see in Soviet society.

4 The idea that shortage is due to this self-fulfilling cycle is also supported by the parallel shortage in the labor market. There is no reason to suspect that managers wanted an artificial shortage of labor, yet there was an incessant problem of excess demand for labor, which is easily explained by the soft budget constraint and labor hoarding (Nove (1986), p. 224; Gregory and Collier (1988); Berliner (1957)).

5 Consumer production became a higher priority according to official sources in the 1960s, however Western researchers observed a trend toward even higher prioritization of military investment occurring at the same time. It isn't clear that the prioritization described by Berliner actually changed very much in the later years.

6 Berliner points to some other problems that may have exacerbated shortage by interrupting the production process. For example, sub-contracts, a key part of the inter-firm supply process, also offered lower premiums for fulfillment.

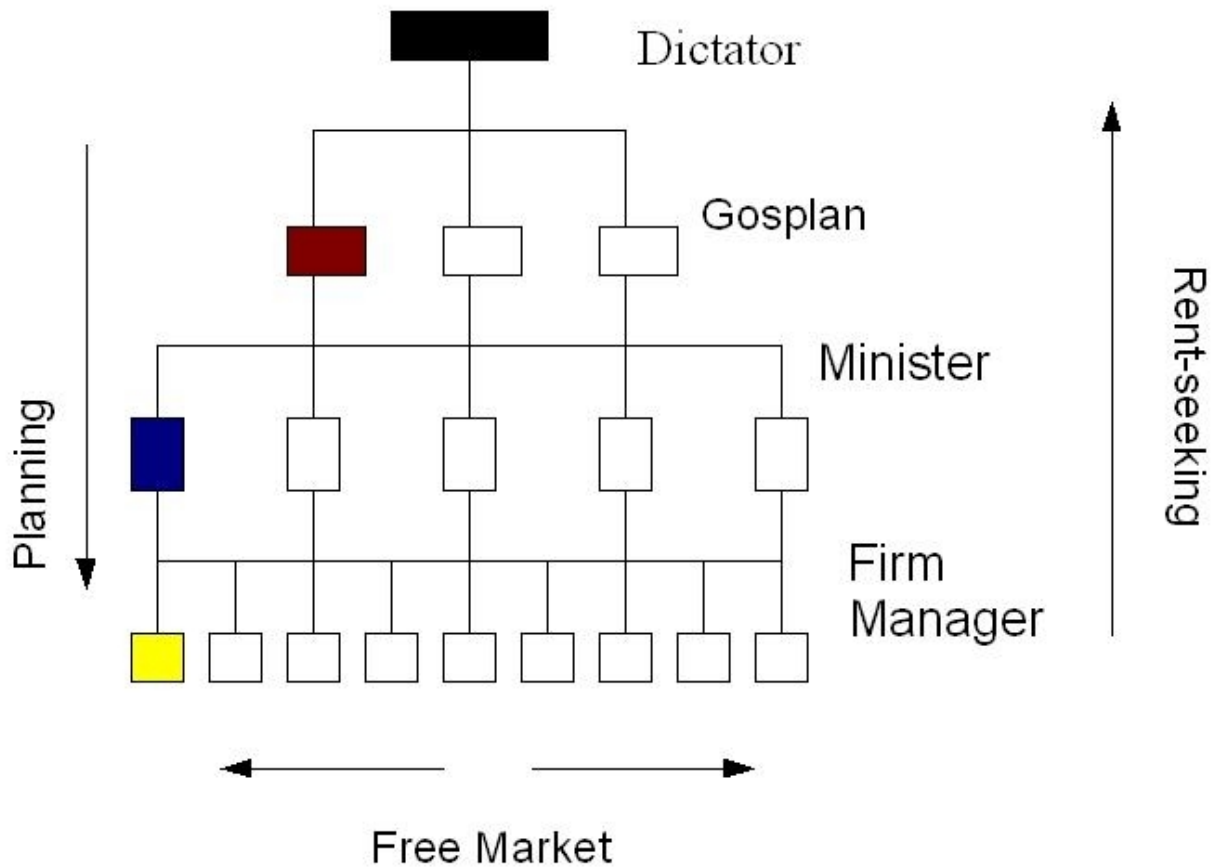
Control of the Hierarchy

The Soviet economy was set up as a hierarchy (Hazard 1968) of nested dictatorships (Gregory and Harrison 2005). Each level in the economy there is a principal who ensures that the agents he is in charge of follow the commands of the plan⁷. Each level is responsible for fulfilling certain targets, and is rewarded for fulfillment and overfulfillment of these targets (Berliner 1957).

Legal scholars of the Soviet system maintain that these laws were generally enforced, with practical deviations from law tending to come in the form of greater hierarchical command (Ioffe and Maggs 1987, see also Krylov 1979: 38). It is possible to imagine, however, that this system might exist on paper only, and that it hides a reality of rent-seeking from below. Shirking at the lowest level of the hierarchy is well known: workers shirk at work. It could be argued that there was also shirking at the higher levels: managers of factories, ministers, Gosplan officials.

If the perceived hierarchical order in a command economy is in fact the reality, then the flow of power travels from top to bottom, from the principal to the agent at the rung below, who, in turn, is a principal of the agent below him. If it is a rent-seeking economy in disguise, then the principals do not actually command the agents below them. Instead, they receive rent-seeking requests from below, and pass the requests up the chain of hierarchical order. The path is followed in reverse: from agent to principal.

⁷ For the most powerful firms the principal is the minister himself, for others it will be a subordinate of the minister, or an equivalent, but there will always be a principal in the hierarchy. "Thus, for every enterprise there is one man who acts as the steward of the state and who, for all practical purposes, is the director's "boss",” Berliner (1957: 17)

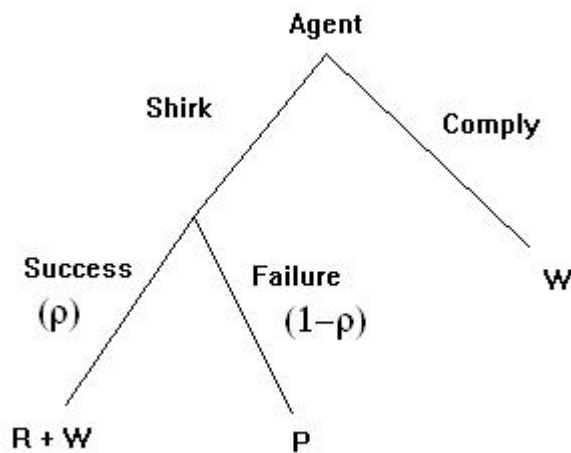


The hierarchy can be seen as a pyramid. The bottom of the pyramid is the firm. Firms in a market economy are independent; they produce whatever maximizes their own utility – profit. In a free market economy, the pyramid ends there at the bottom level. In the socialist system, the manager of the firm manager has a choice: fulfill the plan, or shirk this duty and request that his principal, the minister, collaborate in rent-seeking. In the latter case, the firm would influence the allocation of production through the minister, so that the flow of power would ascend the hierarchy.

The firm manager and the minister would induce shortage and then extract side payments from

the consumer, sharing the proceeds. Shleifer and Vishny (1992) correctly stress the incentive that this rent creates. The incentive of this rent R is potentially much larger than the wage W (and associated premiums) that the firm manager can obtain by complying with the plan, and fulfilling output targets.

However, Shleifer and Vishny do not take into account punishment, which may occur if the principal does not want to collaborate. The evidence indicates that the minister did not collaborate with the manager, under the Soviet system. Here we can see why. For a manager to choose this option, his expected profit from this shirking, R times the probability of success, must outweigh the expected punishment by enough to exceed his wage W , the reward for complying with the nominal command structure. So, $(R \times \rho) - (P \times 1-\rho) > W$. The reward for rent-seeking R is the difference between the low official price and the willingness to pay for the scarce good, multiplied by the number of excess consumers demanding the good, as split between the manager and his principal, the minister.



The manager may know the likely total reward. However, he also must determine the likely

punishment and the probability he will be punished. He must also determine the amount of the reward his principal will demand in order to collaborate. These all depend on the incentive his principal faces. In the nested dictatorship structure, the principal is herself an agent. She faces the same game as the manager. She also has a plan to fulfill and a wage and set of premiums for fulfilling the plan targets. The minister is also the agent for the planning bureaucrat (a Gosplan official). The minister must decide whether her principal will want to collaborate, and allow the redirection of resources requested to stand, or turn her in as a shirker. She must also determine the likely cost of the pay-off for collaboration. Gosplan agents, in turn, must determine these same probabilities.

However, at each level in the hierarchy, there are fewer agents and so the probability of being caught ($1-p$) is higher. At the same time, the wage is also significantly higher, especially due to the benefits received at top levels of the hierarchy. The higher up in the system, the higher the allocation of reward for compliance (Harrison 2008, Berliner 1957). The punishment if caught may also be greater, because the agent has greater responsibility and so her actions would have greater consequence. The extreme punishments under Stalin, including purges of high level officials, may have been used to maximize fear (Lskavyan 2007).

Managers of firms primarily have to face the probability the principal will turn him in, but ministers are fewer, and each one must also face the probability that the party apparatus will turn her in⁸, or that the dictator will himself observe the shirking. In this case, the probability of success is much lower unless the dictator himself is in favor of the rent-seeking. The principal for the Gosplan planners is the dictator.

8 Huge resources were expended to monitor each ministry and report deviations from the plan. It is unlikely that any orders not agreed to by the dictator would have been allowed by this apparatus, so collaboration through the hierarchy would probably have been required (Harrison (2008)).

The party hierarchy acted as a parallel hierarchy that would watch over and help ensure the primary hierarchy of the command structure (Hazard (1968)). Managers, especially of larger firms, would also have had to worry about this danger. Party officials assigned to firms were personally responsible for the plan fulfillment of the firm and had the associated incentives. They might turn a blind eye to gray market activity that helped to fill the plan, but not to collaboration that would go against the plan set by the hierarchy. Large and priority enterprises also had a “special section” of the firm, staffed with police agents, which was there not to ensure plan fulfillment but to report illegal activities whether they helped to fill the plan or not (Berliner (1957)).

There are several possibilities for how the dictator will decide (these are discussed in Gregory 2008). If the dictator is a “scientific planner” then the game must end with no shirking. The scientific dictator model is the traditional model, the command model in which the dictator is benevolent and sets the plan, without any opening for rent-seeking. The dictator has a leading role; he sets the parameters, and is unwilling to make changes to it for reasons of self-interest. Planners below him are to use scientific norms to determine the details of the plan, and if they shirk, they will be punished. To the extent that the shirking requires no collaboration from the dictator, the probability of punishment is still high, due to the visibility of the high level agents, and the monitoring apparatus.

If the dictator is a “referee dictator” as the Boettke and Shleifer and Vishny models would suggest, then if the dictator is interested in his reward R , the output from the rent-seeking (O_{rs}) must exceed the output of the dictator's original plan (O_{pl}) by enough to pay off all the rungs of the ladder required to follow this output plan, $O_{rs} > O_{pl} - (R_1 + R_2 + R_3)$, to leave the dictator with a higher reward for himself. The dictator must be ensured of this with enough confidence to give up control over the plan and risk losing his powerful position. Because rent-seeking is wasteful (Murphy, Shleifer and Vishny 1993) and not capable of maximizing output in the economy, it is unlikely that the dictator would have this confidence.

Gregory (2008) concludes that Stalin fit the stationary bandit description best. Because he did want to enforce his own choices, and had the power to decide all, his agents had no incentive to make decisions of their own and went to Stalin with the smallest of concerns (see also Krylov (1979): 77 and Berliner (1957) for how lower level officials similarly avoid responsibility). This was to reduce their risk – to avoid punishment for improperly implementing the plan. As a stationary bandit, the dictator is already maximizing his utility, and no amount of reward would induce him to collaborate. If he cannot be convinced, and his agents do not have the freedom to make the decisions on their own, then no amount of reward will convince them to collaborate with their agents. In this scenario, too, the game must end with no rent-seeking.

The Driving Force of the Economy

Israel Kirzner (2000) describes competition as the “driving force of the market.” Consumers are sovereign in a market economy and competition, entrepreneurial entry and innovation are the result of the profit-seeking drive of economic actors in a free market system. The institutional structure that forms the basis of the market economy allows self-interest to express itself as profit-seeking; profit-seeking results in competition which tends to drive down monopolistic profits and lead markets in the direction of equilibrium.

Kirzner, speaking of the nature of competition as the driving force of the market even where monopolies exist, argues that “the only situation in which competition can be said to be absent is one in which markets do not operate. Such a situation presumes, as in the centrally planned economy, the existence of institutional prohibitions on market exchanges.” Although competition must operate in any economy in which it is not banned, it may not be the sole driving force. The apparent dichotomy of plan or market may be supplemented with the mixed economy, which has rent-seeking as a second driving force. Yet, this rent-seeking takes the form of lobbying for institutional constraints to prohibit market exchanges in the particular market in which those actors are competing, so the mixed economy is a blending of the same two forces. A pure third system can be theorized: the pure rent-seeking society.

With new institutional economics, more study has been devoted to how the drive of self-interest may be channeled into politics, instead of economics, when the institutions are set up to make this more profitable, so that rent-seeking replaces profit-seeking as the driving force of the economy (Douhan and Henrekson 2007). This constitutes the rent-seeking society (Murphy, Shleifer and Vishny 1993). Self-interest in a command-hierarchical society cannot be channeled to rent-seeking because rent-seeking is a force that comes from below and drives the economy. With rent-seeking, the actor seeking rents makes a political exchange with a more powerful actor the result of which is a modification of the

pricing and output in the economy and a rent which is split between the two actors. Hence, production in the pure rent-seeking society is driven by rent-seeking just as production in the free market economy is driven by profit-seeking.

This rent-seeking is impossible under the institutional constraints both of the pure free market and the pure command system. Under the pure free market system, rent-seeking is impossible because the political actor does not have the ability to change output or prices, due to institutional constraints. In the free market system, the legal system protects the right of the actors at the bottom of the pyramid to determine price and output.

Under the centrally planned hierarchical economy rent-seeking is impossible for the same reason – institutional constraints. The central planner sets output and prices, so the middle-level official in the hierarchical economy has no ability to change prices and output for those below him without breaking the law. Especially in the case of a centrally planned economy, breaking the law is highly dangerous.

Power Seeking in the Command Economy

Instead of profit-seeking or rent-seeking as the driving force, the command economy was a power-seeking society. Boettke points to the *nomenklatura* as evidence to support the model of a rent-seeking society. Yet, as Nove explains (1986:176-7, 327) this is not rent-seeking, with the officials driving shortage to obtain rents, but a hierarchy of distribution by planners to those in power. The officials did enjoy this elite privilege, but it was offered to them by the planner to strengthen their positions of power in the command system and reward obedience. These rewards, in fact, made those at the top of the hierarchy less likely to collaborate with their agents and give in to the temptation of rent-seeking rewards, because they represented an increase in W .

The rewards were not obtained by lobbying officials to induce shortage, but rather they represent compliance being rewarded with privilege. In this way, self-interest was channeled toward

plan-fulfillment and officials could climb a fixed hierarchy to a more powerful position⁹. Nove (1986) explains how rewards and appointments are used to maintain hierarchy (p. 325):

[Communist] party officials believe in discipline, obedience, and hierarchy, because these qualities plainly benefit them and their careers, as well as being (in their view) essential in the running of a vast country and its economy. Their major role in appointments ensures that the managerial strata feel primarily responsible to them. Ministerial, financial, and planning officials may sometimes resent interference from full-time party officials, but share with them an interest in retaining powers vis-a-vis their subordinates in industry and agriculture. The state and party apparatus seems to prefer that not only appointments but also rewards be under its control, that is, that bonuses depend on the fulfillment of plan-orders and not on impersonal market forces or on contracts with other managers. This helps to explain why, despite numerous criticisms, rewards still depend decisively on *plan*-fulfillment (obedience to instructions), rather than on actual achievement measured against some objective criterion.

Of course, officials benefited from their positions and enjoyed their rewards and their privilege. As seen in the distribution of cars studied by Lazarev and Gregory (2002), top officials had privileged access to shortage goods. Low official prices and priority allocation combined to give high officials a highly valuable perquisite. Officials had little interest in losing these rewards, and so they had little interest in raising the prices of these goods above the low planned levels (Nove 1986: 327). However, the fact that they enjoyed the privilege and did not lobby for its change does not mean that they had a part in creating it. Instead, it was a reward to ascending the fixed hierarchy, which in turn re-enforced the hierarchy, solidifying the totalitarian command structure of the economy (Lazarev 2007).

The best way for an individual to maximize income in the command economy was to climb the ladder of command. An ambitious student would excel in the party youth groups and join the party at a

⁹ Lazarev (2005) spoke about the giving of these privileges to officials for compliance, and explains how Stalin would split existing positions in order to pay for compliance from more officials in the hierarchy, until positions had been split so much, and bureaucracy so extended as to have nothing left to offer. Periodic purges allowed Stalin to create new positions for ascending bureaucrats. Perhaps this helps to explain the frequent purges of government that Anderson and Boettke (1993) point to.

young age (Hazard 1968). Similarly, the best way to maximize income as a manager was to maximize “premiums” for fulfilling plan targets¹⁰, and power relations by complying with party officials. The highly successful manager was the manager who understood the politics of the plan: how to prioritize production when the plan gave no precise guideline. Such managers would closely read Party newspapers for clues, and always put Party priorities first (Berliner 1957). Either by joining the party or by complying with party politics and becoming friendly with party members, success in the Soviet system was obtained by staying within the hierarchical structure and ascending its ranks.

The highly successful manager could ascend the power hierarchy, with the pinnacle of success to be part of the *nomenklatura*. Officials would strive for this even if it meant turning in other officials who had violated rules, or if it meant following the plan even when it violated common sense. ascension in the hierarchy of the *nomenklatura* was achieved by political means, not through better skill at management or productivity. The *nomenklatura*, in turn, was a tool for control (Harasamiw 1969). This is the essence of power-seeking: ascending the hierarchy through political means, and then using the position to keep the lower ranks in control.

Rent-Seeking and Decentralization in the Command Economy

Reduced coercion (Harrison 2002) and reduced plan enforcement (Shleifer and Vishny 1991) are blamed for the collapse of the system during perestroika. The reforms of perestroika, whether purposeful or not, weakened the disincentive of punishment for rent-seeking. The potential reward from rent-seeking, and the links in the hierarchy that made available easy opportunities for collaboration, remained when punishment was reduced. However, the balance tipped between reward and fear of punishment, so that collaboration was preferred.

Control is critical for planning. Weakening of control destabilizes the system. If control is

¹⁰ Berliner (1957) documents official acknowledgment of the importance of premiums (e.g., p. 39), despite ideological preference for “socialist competition.” He also presents extensive evidence from manager interviews, and concludes that premiums were the central consideration in decision making by firm managers.

weakened in one industry, other dependent industries suffer. This is one reason that reform failed for so long in the Soviet Union (Nove 1986):

the system has an inner logic that resists *partial* change. Thus if one frees an industry—say clothing—from central control, then what would happen to the industries that provide it with inputs? Unless they too responded to market stimuli (i.e., based their production on orders from the clothing industry), there would be acute problems in ensuring that they produce what is needed.

The usual response to this by planner was to re-centralize immediately, or never to loosen the controls in the first place (Nove 1986). During perestroika, the partial changes were greater, and rent-seeking took hold before the re-centralization was pushed through. Gorbachev introduced a rapid succession of orders that undermined the command apparatus. The system began to weaken. These reforms were still piecemeal and put through before any strengthening of market institutions took place, allowing for rent-seeking opportunities. Along with weakening of hierarchical control, Gorbachev introduced and then Yeltsin expanded, democratic reforms, introducing real democracy with a Duma and direct elections (Desai 2005). Yet, without the protection of private property rights firmly in place, this simply opened wide the door for rent-seeking, and control of prices and output could then shift from a few planners to a larger set of officials in congress.

Weakness leads to opportunism (Solnick 1998), and lack of hierarchical control allows opportunism to become rent-seeking. With the system weakened and areas of the economy available for capture, successful rent-seeking lures rent-seeking by others as officials recognize that they can change output and price without fear of punishment.

The hierarchical system is only top-down because the fear of punishment holds officials back. The underlying tension remains because the reward is still far greater than the wage. Once a sufficient weakness infects the system and it becomes known that deviation from the plan will not be punished the spread of rent-seeking and the collapse of the command of the plan can occur with great speed.

Instead of a single planner, rent-capture leads to a decentralization of control over output and prices to a broader range of officials. Decentralized decision-making becomes the norm almost overnight and the ministers left in charge of the cartels become oligopolies ruling over the economy. This is what occurred when the controls became loose during the latter part of perestroika. Like a taut rope wrapped around a pole, once it broke the whole planned system unwound in a flash. The new organization of the Russian economy after the collapse represents a model rent-seeking economy.

Rent Seeking and Centralization of Market Economies

In the pure free market system, rent-seeking is not possible because the institutions in place outlaw any action by government that results in the directing of production by an agreement between firms and government officials. When a market economy allows for such coercion, the rent-seeking activity leads to a centralization of the economy as the output and price decisions pass from the bottom level of the pyramid (the firm) to the next level up (ministers, or low-ranking state officials).

Rent seeking is socially costly but offers private economies of scale in market economies (Kreuger 1974, Acemoglu and Verdier 2000, Murphy, Shleifer and Vishny 1993). In a market economy rent-seeking may be outlawed if government action is restricted by a constitution. In this case, firm managers and ministers may find that the reward is not sufficient to induce collaboration ($P \times \rho$ is too great). However, very often rent-seeking is allowed by law. In this case, the only punishment that ministers face is retribution by the population, perhaps through being voted out of office. This may not be of much concern if rent-seekers can offer votes or campaign funds in exchange for rents.

The successful rent-seeker captures the power of the minister to alter the output or price in the market. The lower level actor (the firm) collaborates with a higher level actor (the minister) and uses the power of the higher level office to control production. This transforms the economy from a decentralized market to a more centralized economic form in which a smaller number of actors determine output and price. Although rent-seeking has a certain momentum due to inherent economies

of scale, the speed of centralization from a market economy to a rent-seeking society is not nearly as fast as the collapse of the centrally planned system. Although, once it becomes impossible to compete without lobbying government, the consolidation may accelerate (Murphy, Shleifer and Vishny 1993).

The more centralized form of the rent-seeking society may be unstable, whether it is reached by decentralization from command, or centralization from market form. The rent-seeking society tends to be wasteful and arbitrary because resources are allocated according to politically motivated decisions by a small number of officials. It may also be unstable because those officials may then find that higher level officials want a part of the proceeds. High level officials may then consolidate decision making for the whole industry, purporting to offer fairness or stability over a larger group.

If decisions are not made at the individual level, with free exchange, then it is possible that the group making the decisions will need to be as small as possible, otherwise disagreement over priorities, and fighting over proceeds, will tend to make coordination impossible. This is the argument made by F.A. Hayek (1944). The rent-seeking equilibrium may offer a window for a smaller group of planners to take control and bring “rationality” to the system. This would be the turning point at which the market economy becomes a planned economy.

Conclusion

The relationship of rent-seeking to centralization and comparative economic systems is an important consideration for policy analysis and transition and development economics. A clear understanding of the centrally planned economic system, and the incentives that faced actors in it, helps to illuminate the role of rent-seeking in both kinds of economic system.

Rent-seeking can slowly transform a market system, making it more centralized and potentially unstable. Rent-seeking also lies beneath the surface of a planned economy waiting for an opportunity to take over. Rent-seeking cannot exist in a centrally planned system because the hierarchy of control prevents collaboration through the system of rewards and punishments. Yet, once the planned economy

is pierced and made unstable, and fear of punishment subsides, a collapse from planning to a rent-seeking society occurs quickly. The hierarchy of planning is conducive to the cartel-like nature of rent-dominated economies, and the incentive to manage the economy in a way to extract rents is difficult to resist given the institutions and uncertainties in place.

Rent-seeking is a force different from profit-seeking of the market economy and power-seeking of the command economy, but it bridges the two systems by its ability to centralize the former and decentralize the latter system.

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