

## Comments on Chapter 8

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“Who killed the Soviet Union?” “Can the Russia economy rise from the dead?” Paul Stephan answers these questions using collective choice theory. I will restate his answer briefly, as I understand it, using the language of economics. When Gorbachev deflected Soviet history towards liberalization and democracy, many observers thought a benevolent man changed history. No doubt Gorbachev was benevolent compared with his predecessors, and perhaps he personally affected history. However, he directed reforms from his position as head of the Communist Party. The Communist Party, which formed the real government behind the facade of official state offices, was a self-seeking centralized bureaucracy. A satisfactory explanation of the changes under Gorbachov must begin with the Communist Party’s perceived self-interest.

The highest party officials controlled the economy for over seventy years by central planning. The chain of command stretched a long way from Moscow to shop floors in factories on two continents. The probability was low of central authorities detecting disobedience by officials located down the chain of command. How did officials sustain discipline? By terror. Under Stalin, draconian punishment overcame the low probability of detecting disobedience. After Stalin’s death, however, the willingness of the state to use terror diminished. Given a reduction in the severity of punishment, its probability needed to increase to sustain obedience. Unfortunately for the central authorities, the probability of detecting disobedience decreased as the complexity of the economy increased. With less terror and more complexity, discipline decayed. In other words, the agency problem became unsolvable when the severity of sanctions and their probability declined.

Intermediate institutions were located in the chain of command in between central authorities and local producers. The breakdown in discipline caused the intermediate institutions to increase in power. Thus the last decade of Soviet history saw the ministries in Moscow struggling unsuccessfully to control regional authorities. As intermediate officials captured an increasing share of the economic surplus, the central authorities tried various means to recoup their position. Gorbachov hoped to cut out intermediate officials by granting greater power to local officials.

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## ECONOMIC DIMENSIONS IN INTERNATIONAL LAW

Transferring power to the periphery was, according to Stephan, the strategy of the center against the intermediate authorities. In effect, the Communist Party hoped to convert the command economy into something closer to a tax economy. In the converted economy, local officials would enjoy more discretion, which was supposed to result in greater productivity. Local officials would keep part of the economic surplus and remit the remainder to central officials. The increase in wealth and discretion would secure the political loyalty of the periphery.

This plan contained two fatal miscalculations. First, the Communist Party was too unpopular to withstand political competition. Second, private law could not be revived quick enough for true economic liberalization to increase production. I follow Stephan by elaborating on the second miscalculation. Secure private property and enforceable contracts are necessary to a modern economy. Under the old command economy, property and contract law were weak or absent, but some substitutes were found. Private property is "protected discretion," by which I mean that owners have the right to use their resources as they see fit, including selling them, and the law forbids other people from interfering when owners exercise their rights. Patrons at the center protected the use of resources by their clients at the periphery in exchange for tribute. Discretion enabled the local officials to get on with the task of production. Before the tumultuous death of the Soviet Union, officials changed office relatively slowly, which permitted them to form long-run relationships. In long-run relationships, economic actors secured cooperation without enforceable contracts by reciprocity – each does "favors" for the other so long as they are reciprocated. So a patronage system in a stable hierarchy of power provided a partial substitute for private property and contracts.

As the chain of command weakened, however, these substitutes became unworkable. Central officials lost the power to protect their clients from interference, so power over resources in Russia today is very insecure. As for contracts, political turmoil has created so much uncertainty that officials heavily discount the probability of continuing to deal with each other in the future. The courts cannot enforce contracts, and fluidity prevents reciprocity from emerging as a substitute. In technical terms, the "end game is noncooperative." In economic theory, large cartels disintegrate into competition. The economic and political cartel of the Communist Party, however, has disintegrated into a condition resembling anarchy more than competition.

True liberalization requires privatization, whereby public ownership of resources converts to private ownership. The living property law of Russia is too weak for true privatization to occur. Instead, Russia has

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experienced what Stephan calls "spurious privatization." I am tempted to contrast true and spurious privatization by coining a new word. Legal theory contrasts ownership and possession. "Privatization" means the conversion from public to private *ownership*. Define "possessitization" as the conversion of public ownership to private *possession*. Privatization is liberalization, whereas possessitization resembles anarchy. Poland, the Czech Republic, and Hungary are privatizing. Russia is possessitizing. China occupies an intermediate position because its private enterprises depend upon protection from powerful political patrons, not law.

Russians in the command economy overstated production to obtain bonuses, whereas under current conditions Russians understate production to avoid taxes. Consequently, the sharp descent in official production statistics cannot be accepted on its face. Even so, production has declined in Russia. To reverse the trend, production must become more profitable than stealing the state's property. As state property diminishes this condition will be reached more quickly in some sectors than in others. Stealing manufactured goods and agricultural products, whose production requires much labor, sharply reduces their supply. Consequently, the absence of private law causes a sharp decline of production in manufacturing and agriculture. In contrast, the value of accessible natural resources depends upon their scarcity, not the labor that goes into extracting them. Stealing accessible natural resources redistributes wealth without reducing the supply. Thus the people who control organizations with weapons will be drawn especially to sectors supplying natural resources.

This point can be restated in different language. Manufacturing and agriculture yield profits, whereas access to natural resources yields rents. Stealing profits reduces wealth, whereas stealing rents redistributes wealth. People who specialize in power seek rents more than profits.

How can Russia secure private property and enforceable contracts? Drafting more statutes with the help of foreign experts is the legal equivalent of shock therapy. I doubt that the corpse of private law in Russia will respond under current conditions. Statutes are easier to enact and hard to enforce. Perhaps a strong man will seize control and impose new law by military force. That is an old tradition that I hope Russia abandons. Alternatively, ownership may gradually evolve out of possession. The evolutionary approach requires the development of a community of judges, lawyers, and scholars to examine business practice in Russia and commend for state enforcement those norms that promote cooperation and competition.