

V. PAPAVAL AND N. KHADURI

# On the Shadow Political Economy of the Post-Communist Transformation

## An Institutional Analysis

### Introduction

Any economic system in any country in the world, especially at the end of the current century, is a unique synthesis of legal and illegal—shadow economic activity. The illegal, hidden economy functions on a par with the legal economy, has enormous dimensions, and in some countries practically does not yield to the legal economy in its dimensions.

The shadow economy as a phenomenon originated in ancient times and functions "successfully" up to the present, at a time when its scale is not only expanding in practice but also assumes myriad forms. Despite its centuries-old history, the shadow economy has not yet become a subject of special, comprehensive political-economic study. In its investigation of general economic principles, political economy has almost never focused its attention on problems of the shadow economy: it has either ignored them or believed that the economic mechanisms in a shadow economy are the same as those operating in a legal economy. Because of such an artificially simplified view of a shadow economy, we unfortunately still do not have a very clear understanding of the mechanisms of a shadow economy, as a result of which the steps that are taken to eradicate it are frequently ineffective.

English translation © 1998 by M.E. Sharpe, Inc. "O tencvoi politicheskoi ekonomii posikommunisticheskoi transformatsii (inslitsional'nyi analiz)." Original manuscript, July 1997, 18 pp.

Professor Vladimer Papava is Minister of the Economy of Georgia and Scientific Supervisor of the P. Gugushvili Institute of Economics (Georgian Academy of Sciences). Nodar Khaduri is a junior researcher at the same institute.

Proceeding from what has been said above, it seems necessary' to carry out a comprehensive political-economic study of a shadow economy on the basis of available empirical material. We shall tentatively call the political economy of a shadow economy *shadow political economy*.

The shadow economy uses the same resources and markets as the legal economy with the sole distinction that all this takes place without the recognition of the state and indeed in some cases even without its knowledge. Although economists do not dispute this fact in principle, there is still no consensus among them on the definition of a shadow economy.

There is a widely held concept of the shadow economy as secret, illegal activity that is not taken into account. It is frequently associated with criminal ways of obtaining income, that is, with economic infractions and crimes as well as with organized crime, corruption, and lobbying of various decisions of organs of state power. However, concentrating solely on the criminal manifestations of the shadow economy means not getting to the heart of the problem and making it impossible to find ways to reduce its dimensions. We should not delude ourselves with the notion that a shadow economy is solely connected with criminal activity, this sphere frequently also includes activities that are entirely respectable and beneficial to society.

Unfortunately, levers that are in any way effective in influencing the shadow economy to any degree have not yet been created and the entire arsenal of methods for combating it is usually confined to administratively or criminally punitive measures, which, of course, cannot by any means always lead to the desired results.

The shadow economy as a phenomenon has been relatively well studied for countries with developed market economies.<sup>1</sup> Works are appearing on the study of the shadow economy in the developing countries. Despite ideological barriers, in the 1980s, it began to be openly studied in former, communist-type socialist countries (i.e., in communist-type countries). However, little is known about the shadow economy in countries in which post-communist reforms are being carried out.

The purpose of the present article is to present a theoretical picture of the essence of the shadow economy, to reveal the principles of its transformation in post-communist development.

The institutional analytical framework of the shadow economy

In revealing the essence of the shadow economy, the use of the approaches of the "new institutional economic theory" is especially effective.

According to this theory, the actions and interrelations of people are

outlined by the institutional structure of society, which, within the framework of a given period of time, determines the various boundaries of human behavior. The institutions themselves are the aggregate of formal and informal (commonly accepted norms of behavior, verbal agreements, etc.) restrictions and mechanisms of coercion (through education in the spirit of these restrictions and punishment for their violation) to observe (these restrictions). Formal institutions (FIs) are usually presented in written law.

It must be noted that FIs and informal institutions (IIs) are characterized by a high degree of reciprocal influence: FIs are those already in existence or desired IIs that have been reflected in written law; the developmental trends of IIs are influenced by newly emerged FIs. As the most graphic example of the impact of IIs on FIs, developed market systems, in which many legislative acts regulating the economy were adopted on the basis of commonly accepted norms of human behavior in a competitive environment, should be acknowledged. No less graphic an example of the reverse impact of FIs on IIs are economic systems of the communist type, in which FIs were created from good intentions to artificially transform and "improve" people, as a result of which certain IIs atrophied.

In order to depict the relationship between FIs and IIs, let us examine Figure I. in which they are conditionally represented in the form of intersecting circles.

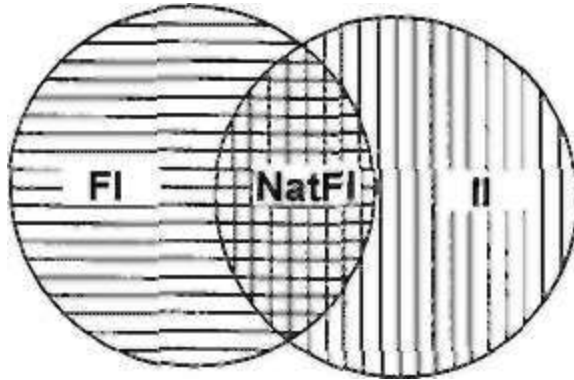
Because some FIs form on the basis of the reflection of certain IIs in written law, sets FI and II intersect. We call this part of the FIs natural FIs (NatFIs). The NatFI set is the intersection of sets FI and II. The larger the NatFI set is, the more FIs correspond to human nature. It must be noted that sets FI and NatFI can never coincide entirely: first, not all IIs can be reflected in written law (nor, indeed, is this always necessary); and, second, FIs will also always contain some that, based on the developmental goals of a given society, reflect not only existing IIs but also necessary restrictions and mechanisms compelling their observance (i.e., unnatural FIs—[UFIs]).

In non-communist-type countries, UFIs exceeded NatFIs many times, which, other things being equal, determined the lack of viability of such economic systems. In countries with developed market democracies, on the other hand, the share of NatFIs in the FI aggregate is significantly greater.

FIs, above all else, are the basis of the legal economy in any society. The defining principle of the shadow economy is the ignoring of FIs, when the actions of people are in no way subordinate to the demands of these institutions and are regulated exclusively by IIs. Here, too, the logical question arises: are all informal institutions at the basis of the shadow economy?

Of course, the answer to this question is negative. The explanation is that a certain part of the IIs complement the FIs. These IIs, together with the FIs,

Figure 1. Correlation of Aggregates of Formal Institutions and Informal Institutions



(FI = formal institution; NatFI = natural formal institution; II = informal institution.)

create an environment for the legal activity of people, including economic activity. From the positions of FIs, such IIs appear to be *rational*. Accordingly, we shall call those IIs that complement formal institutions and thereby create a basis for the legal activity of people *rational (RIIs)*.

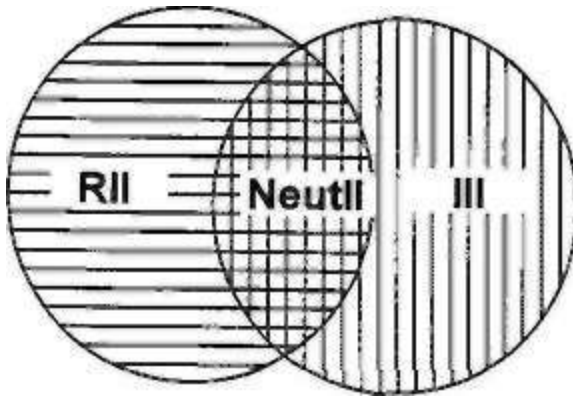
Out of the entire aggregate of IIs, the shadow economy is primarily based on those that ignore FIs. From the positions of the latter, such informal institutions may be called *irrational*. Accordingly, those IIs that ignore formal [institutions] and thereby create an environment for the illegal, shadow activity of people will be called *irrational (IIIs)*.

Can it be said that the sum of all RIIs and IIIs comprises the entire aggregate of IIs? To all appearances, it cannot. The fact is that both aggregates of RIIs and IIIs simultaneously include in their structures the same IIs that "with equal success" do not contradict FIs and complement those IIs that essentially contradict FIs. In other words, both aggregates of RIIs and IIIs contain the same subset of IIs that in their nature are *neutral (NeutIIs)*. The latter include in their structure the most commonly recognized elementary norms of behavior that have formed in society over quite a long period of time (sometimes even centuries); for example, behavior norms that include elements of compassion on the part of the strong for the weak, who acknowledge this.

In order to depict the interrelations of RIIs, IIIs, and NeutIIs, let us examine Figure 2.

The intersection of sets RII and III is the aggregate NcutII.

Figure 2. Correlation of Aggregates of Rational Informal Institutions, Neutral Informal Institutions, and Irrational Informal Institutions



jRII - rational informal institution, NeutII = neutral informal institution: III ~ irrational informal institution.!

The mechanisms of change of various IIs differ from each other.

NeutIIs are the most stable; they are the least subject to the influence of FIs. NeutIIs are closest to the very essence of man and are therefore more conservative.

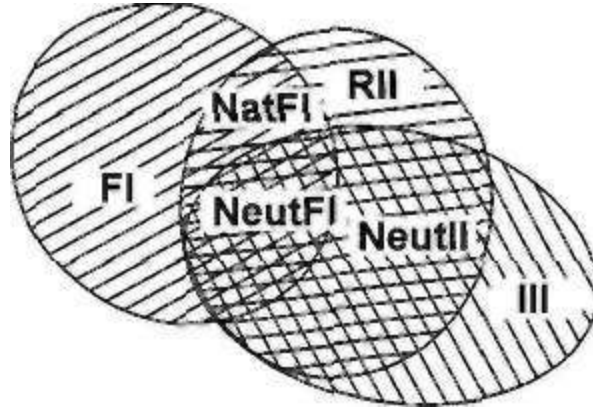
Some NeutIIs are reflected in natural FIs, as a result of which the latter are most stable in the structure of the natural FIs and all the more so in the entire aggregate of FIs. This part of the natural FIs may be classified as *neutral FIs (NeutFIs)*.

Combining Figures 1 and 2, we obtain the depiction of the correlation of all FIs and IIs (see Figure 3).

When various changes take place in the economic structure of society, they are first of all reflected in FIs. When these changes are relatively insignificant, some FIs are seemingly smoothly replaced by new FIs. But when the changes are significant, the majority of the FIs are destroyed and it is not always possible to create new ones to take the place of the old. It should be noted that, even in the ideal case in which the goals of transformations in the economic structure of society are clear, and even with the most complete knowledge of which new FIs are needed and how they should be created (which in itself is by no means always obvious), there is no assurance that these new institutions will be created in good time. This is above all impeded by the inertness of economic and social processes.

The vacuum that forms in the structure of FIs exerts a direct negative impact on RIIs: a portion of them disappear as the corresponding FIs are destroyed. This vacuum in the structures of FIs and RIIs is filled with

Figure 3. Correlation of All Types of Aggregates of Formal Institutions and Informal Institutions



[FI \* formal institution; NatFI • natural formal institution, RII = rational informal institution; NeutFI = neutral formal institution; NeutII = neutral informal institution; III<sup>B</sup> irrational informal institution.)

proliferating IIIs. This is precisely the reason that in countries making the transition from one economic system to another, the scale of the shadow economy grows significantly. The most graphic example of the total destruction of old FIs, simultaneously with the disappearance of the corresponding RIIs and the replacement of both of them by proliferating irrational informal institutions is Georgia in 1993-95, where the scale of the shadow economy increased to 80 percent. An example of the most purposeful and sensible transformations is post-communist Hungary, where the scale of the shadow economy reached 25 percent.

Thus, during the transition from one economic system to another, the area of circle FI in Figure 1 is reduced, while the area of circle II expands. Similarly, the area of circle RII in Figure 2 diminishes and the area of circle III expands. During this transformation of the economic system, NatIIs are the most stable and remain virtually unchanged, which guarantees a relatively more stable position of UFIs (unnatural formal institutions) in the entire aggregate of FIs. If any types of UFIs are nevertheless destroyed, it is not so bad, because the corresponding NatIIs regulate the given processes without detriment to the interests of all society. Those natural FIs that are not a part of neutral FIs are more subject to change than the latter.

Significant destruction in the structure of FIs and RIIs and their replacement by IIIs (which do not and cannot in principle belong to NeutIIs) is fraught with the most serious manifestations of the criminalization of the economy and its management.

The special role of the portion of Neutlls that does not belong to NeutFIs, when, at the same time, they compose part of the two aggregates of Rlls and Ills, results in some types of shadow activity that are inoffensive and not of an antisocial, antihuman nature. The legalization of these types of shadow activity is impeded by imperfections in FIs; any improvement in them promotes the greater legalization of the given types of activity, but since in principle absolutely perfect FIs cannot be created, in any society certain types of entirely inoffensive types of economic activity will always remain in the shadow economy.

Based on institutional analysis of the shadow economy, it is easier to examine forms of manifestation of the shadow economy in countries with developed market orientations and with communist-type economic systems.

### **Characteristics of the shadow economy in countries with developed market systems and communist-type economic systems**

**In** order to study the characteristics of the shadow economy in countries undergoing post-communist transformation, it is necessary to know "where they have come from and where they are going," that is, the characteristics of the shadow economy in countries with developed market systems and in countries with communist-type economies.

It must be noted that according to experts' estimates, in countries with market systems, the shadow economy accounts for 5-20 percent of gross national product. Of course, these indicators cannot be precise, but it is possible to obtain an approximate understanding of the size of the shadow economy.

It is widely believed that the shadow economy "operates" exclusively with cash; checks, bills of exchange, and other means of payment are not as liquid and may be detectable; in a shadow economy there are practically no payments through banks. It can definitely be stated that tax evasion is almost always possible when cash is used. Here it is appropriate to emphasize that the concealment of income with **the** intent to evade paying taxes is one of the principal features of the shadow economy.

Every tax is interference by the state in the functioning of a market economy, and it limits the market's potential to make maximum use of resources. At the same time, taxes are the price paid for the possibility of enjoying social goods. However, in many cases, tax evasion is attempted regardless of the size of earnings. The reason is clear and understandable: there is hardly anyone who will not try to obtain goods or services free of charge or at least for a lower price. And here, administrative methods

alone, or patriotic appeals that the power of the state, well-being, security, and protection of civil rights depend directly on state budget receipts, are insufficient. The ideal salvation from the "disease" of nonpayment of taxes would be the creation of a system in which the taxpayer would be interested to the maximum degree in paying taxes in full and on schedule rather than in evading their payment.

The shadow economy brings about the lowering of state and local taxes. But it should be noted that if it were entirely eliminated, some work would not be performed at all or would be performed by customers themselves (once again, without the payment of taxes). It must be remembered that because money earned in the shadow economy as a rule ends up in the legal economy, everything is nevertheless indirectly taxed. Thus, "shadow figures" also "pay" taxes, but do so indirectly. And it has been established that if tax agencies curb the concealment of income in the early stage of functioning of such a shadow figure, the budget may lose more than it gains. This segment of the shadow economy is regulated by Neutlls. and some of them even by NeutFIs as well.

It is usually difficult to say what money is "shadow" money and what money is not. "Shadow" money is considered to be money that is, or that circulates, in the shadow economy. Money that is criminally obtained (from robberies, drug, and arms traffic, brothels, etc.) is also considered "shadow"<sup>7</sup> money. As a rule, part of the shadow money is left for the expansion of "shadow business," which is natural because it is the principal source of financing of the shadow economy. Unfortunately, capital from the legal part of the economic system is frequently invested in the shadow economy. This may be considered due to the state's inability (and sometimes also reluctance) to fight against it.

Relations with the shadow economy in former communist-type countries were particularly painful. After 1917, an experiment to build communism on an unprecedented scale began on one-sixth of the earth. An unprecedented fight against private property began. It was specifically private property that was recognized as mankind's principal misfortune. The economy began developing in an unnatural way and as a result there was also great distortion of its component part—the shadow economy, which went virtually unrecognized until Gorbachev's Perestroika began

If those going into the "shadows" in countries with market economics did so primarily in connection with tax evasion, in communist-type countries everything was much more complex. The most prevalent types of shadow activity were the padding of performance figures and other distortions of plan fulfillment data; the production of inferior, substandard, or incomplete products; theft on the job; misappropriation of state property



through the abuse of one's official position; and bribe-taking. All society was drawn into the shadow economy. However, any manifestation of this activity was for quite a long time treated as being the result of individual asocial inclinations of individual citizens, against whom various punitive measures were applied. But, most importantly, the question of combating the roots of this disease was never raised once. Nor could it be raised in connection with the very essence of the communist-type economy.

The existence of the shadow economy was entirely determined by the FIs of the administrative-command system of economic management, which was manifested in the strict planning of the production of goods and services and in the distribution of resources. In our opinion, the most successful and, moreover, the most complete classification of the shadow economy in communist-type countries was made by A.N. Shokhin. In particular, he believes that the shadow economy consists of the unlegalized segment of the "second" economy, the informal economy, the fictitious economy, and the "black" economy.

The "secondary" economy is understood to mean all those forms of production activity that, as a rule, were previously considered as having no prospects: individual labor activity and small-group production. Consequently, the "first" economy is understood to mean large-scale state and collective farm production.

The "second" economy is frequently compared with an iceberg: only a small part of it is registered and taxed. The bulk of the "second" economy is hidden from regulatory agencies (we emphasize that it is hidden from regulatory agencies, but not from various kinds of inspectors and law enforcers). And this is despite the fact that no one has officially prohibited individual labor activity. However, discriminatory taxation and society's attitude toward it as a "rudiment" forced those engaged in individual labor activity to work illegally. Furthermore, they harbored a fear of "dekulakization." The "second" economy is primarily regulated by RIIs.

When the reasons for the preservation of the shadow economy are examined, it is usually noted that in communist-type countries some of the "shadow figures" of the "second" economy were not interested in legalizing their activity for both psychological and purely financial considerations. Here it is necessary to consider not only legal taxes but also the system in the form of *illegal taxes* that forced entrepreneurs to pay much larger sums "on the side" to local (and not only local) authorities and to the police (starting with the district inspector and higher). In other words, the result of the illegal state of the "secondary" economy was that some FIs also edged their way into its regulatory mechanism in the form of RIIs.

The basic mechanism of functioning of the second element of the

shadow economy—the informal economy—is the system of centralized planning and the practical exclusion of economic methods of management from the work.

Administrative-command methods of management almost always compelled workers to act within the framework of the adopted procedures for implementing managerial and planning decisions. Such actions originated as a mode of adaptation. They frequently became distorted and thus distorted the management system itself.

The system of planning was built on the principle "from the achieved level."<sup>1</sup> This in turn generated a system of "tenders," whose participants were, on the one hand, enterprises and branch departments and, on the other, central planning organs in the form of Gosplan (State Planning Commission). The formulation of a plan that pleased all participants was the subject of the tenders. The "status quo" principle was the means that Gosplan used to place pressure on a branch or on enterprises.

The possibility of obtaining a "good" plan opened up broad opportunities for using material resources to obtain "illegal" income. Accordingly, managers of enterprises did their utmost and used fair means or foul to make sure that the plan did not correspond to enterprises' real potential.

The most characteristic feature of the Soviet economy was overfulfillment of the plan. Overfulfillment of the plan offered a number of appreciable gains and advantages. Precisely this overfulfillment of the plan was the principal factor in incentives and professional advancement. It also encouraged enterprise managers to strive to obtain a lower plan. Clearly, agreements regarding a lower plan were usually dictated by selfish motives.

Sometimes the plan could also be raised at the "request" and desire of producers whereupon it was fulfilled at any price to the detriment of both (the environment and state interests. However, it was specifically this detriment that yielded superhigh shadow income.

The informal economy was manifested not only in manipulations of the plan, but also in the functioning of the system for the distribution of the means of production. Every enterprise director tried to obtain the maximum quantity of means of production from central distribution organs of economic management, and, therefore, most enterprises had huge, above-norm inventories of raw materials, equipment, and other scarce resources. This excess formed on the basis of informal deals and, of course, was by no means devoid of selfish interests. Given the use of a system for writing off supposedly worn-out equipment and spoiled raw materials, this excess was a significant source of illegal enrichment.

All these selfish actions were based on the bribe-taking mechanism, which in countries with developed market economics differs radically from

that in countries with communist-type economic systems. In particular, while in the former bribes are usually given for actions that the law does not allow, in the latter bribes in the great majority of cases are given for entirely lawful actions.

The informal economy is realized by ILLs, including both Neutlls and UFIs.

The padding of performance figures and other violations of plan and financial accountability were one form of manifestation of the shadow economy. Thus, an entire sector of the shadow economy existed—the fictitious economy. It made it possible to obtain unlawful income by seemingly entirely lawful means. This applies above all to padding.

Padding was used to obtain unearned income in the form of wages, bonuses, or material rewards. One type of the fictitious economy, and thus of obtaining unlawful income, has been the sale of resources obtained after the violation of standards due to the worsening of quality and the production of incomplete products. The communist-type economy "specialized" in the production of inferior-quality products. The production of products for "export" was the peak of cynicism. The same enterprises that produced inferior products for domestic consumption also produced far better products for delivery to foreign countries. This created conditions enabling enterprise managers to earn considerable money by padding and falsifying reports.

Padding was also used to attract and retain workers. It was frequently the practice to offer unduly high wages and to misuse various funds. Such practices were often used to maintain production because personnel turnover at most enterprises not only made it impossible to expand production but even to maintain it at the same level. All this was done with only one goal: to obtain superhigh unlawful income. Such violations have been particularly frequent in construction.

The principal regulators of the fictitious economy were ILLs, with the exception of the part of Neutlls that did not belong to UFIs.

The peak of the shadow economy in communist-type countries was the "black" economy. Even when the strictest management techniques were employed, when everything "iioncontmunist" was persecuted, the proportions of the underground economy attained enormous scale. Entire enterprises or parts of them were left out of the reckoning and worked exclusively for the "black" economy.

Virtually all state enterprises produced both officially known, planned, often inferior and substandard products, as well as products "on die left" that are concealed, primarily quality products, and, most important, that are in short supply. An underground study was made of the consumer market

with the exception of socially unacceptable types of activity (for example, the production of drugs), falls under the heading of shadow entrepreneurship. Part of the informal economy in the form of interpersonal relationships within the framework of administrative-command procedures of planning-managerial activity is related to parasitism while the other part—in the form of illegal economic methods of management—is related to shadow entrepreneurship. Part of the "black" economy in the form of its formal links is related to shadow entrepreneurship, while the remaining part of the "black" economy is related to parasitism.

With some reservations, it may nevertheless be considered that shadow entrepreneurship was of a progressive nature as the embryonic state of market interrelations in the communist-type economic system.

Characteristics of the shadow economy in countries that have undergone the post-communist transformation

Several years ago, most communist-type countries launched democratic reforms with the aim of returning the economic system to a natural channel of development. In the course of several years, these countries had to travel the same road that had been traveled by countries with developed market systems.

In this short period of time, there had to be change both in the economic system itself and, above all, in man, who had to change this system. The restructuring of the way of thinking is the most difficult-to-surmount fruit of the reform.

In communist-type countries, an image of man has formed that the literature calls "homo sovieticus," that is, a person who is entirely dependent on the state and who fears the state. The classic image of man in a market economy is Adam Smith's "homo economicus," who tries to improve his lot gradually and to realize maximum gain. Despite the facts that the dispute about the existence of "economic man" had already begun in the last century, and that to this very day some economists cite quite weighty arguments regarding the disappearance of "economic man," while others cite no less weighty arguments regarding his existence to this very day,<sup>16</sup> we should nevertheless recognize that there have been fundamental changes in economic stimuli that influence man's behavior in an economy with a developed market system even though the striving for gain in its modern understanding remains the same. Considering the special impact of FIs and IIs on human behavior, it may be stated conditionally that modern man in countries with developed market systems is an *institutional economic man* or, for short, an *institutional man*.

and, unlike the state, which planned the production of consumer and producer goods according to the administrative principle (without any study of the market, thus later forcing enterprises to produce products no one needed and consumers to buy them), "illegal" production was limited to what was required by consumer demand

Considerable economic detriment to the population resulted from products that do not satisfy its requirements. Such a segment of the economy in communist-type countries was not officially considered an integral part of the shadow economy, but considering the damage it inflicts on the population, this activity should also be viewed through the prism of the shadow economy. The sale of inferior products was due to the abnormal status of trade, the rightless position of the consumer, and disproportions in supply and demand. These processes were for the most part regulated by UPIs.

Thus, the state inflicted more damage on all of society than the "black" economy.

This part of the "black" economy was regulated exclusively by Rlls, including Neutlls and UPIs; certain Ills that did not belong to the Ncutlls occasionally also found their way into this regulatory system.

One of the component parts of the "black" economy is the "black" market. The "black" market specialized exclusively in the consumer sector. Speculation and all manner of machinations involving scarcity were related to it.

In the "black" market, there was a segment in which, despite the strictest prohibitions, wholesale and retail trade, primarily in imported products, was organized. For these purposes, places known to everyone were used, to which people who had money came and bought what they wanted; that is, in the "desert" of the communist-type economy, there were small market "oases."

This activity was regulated by Ncutlls.

The "black" economy also included officially prohibited types of activity like prostitution, the use of services of hired killers, the drug business, and so forth. All these types of activity were regulated exclusively by His. It must be noted that in this part of the "black" economy, there may also be a certain degree of intersection with the "second" economy when, for example, drugs are produced as a cottage industry.

Thus, in a shadow economy it is possible to tentatively identify two, frequently closely intertwined spheres of activity: (1) the first of these is shadow entrepreneurship, which embraces illegal activity in the production, sale, and servicing of products; (2) the second embraces parasitism, speculation, and various types of activity in the form of padding, extortion, and the like. It should be noted here that the bulk of the "second" economy.

with the exception of socially unacceptable types of activity (for example, the production of drugs), falls under the heading of shadow entrepreneurship. Part of the informal economy in the form of interpersonal relationships within the framework of administrative-command procedures of planning-managenal activity is related to parasitism while the other part—in the form of illegal economic methods of management—is related to shadow entrepreneurship. Part of the "black" economy in the form of its formal links is related to shadow entrepreneurship, while the remaining part of the "black" economy is related to parasitism.

With some reservations, it may nevertheless be considered that shadow entrepreneurship was of a progressive nature as the embryonic state of market interrelations in the communist-type economic system.

Characteristics of the shadow economy in countries that have undergone the post-communist transformation

Several years ago, most communist-type countries launched democratic reforms with the aim of reluming the economic system to a natural channel of development. In the course of several years, these countries had to travel the same road that had been traveled by countries with developed market systems.

In this short period of time, there had to be change both in the economic system itself and, above all, in man, who had to change this system. The restructuring of the way of thinking is the most difficult-to-surmount fruit of the reform.

In communist-type countries, an image of man has formed that the literature calls "homo sovicticus," that is, a person who is entirely dependent on the state and who fears the state. The classic image of man in a market economy is Adam Smith's "homo cconomicus." who tries to improve his lot gradually and to realize maximum gain. Despite the facts that the dispute about the existence of "economic man" had already begun in the last century, ' and that to this very day some economists cite quite weighty arguments regarding the disappearance of "economic man," while others cite no less weighty arguments regarding his existence to this very day, we should nevertheless recognize that there have been fundamental changes in economic stimuli that influence man's behavior in an economy with a developed market system even though the striving for gain in its modem understanding remains the same. Considering the special impact of FIs and lis on human behavior, it may be stated conditionally that modem man Ln countries with developed market systems is an *institutional economic man* or, for short, an *institutional man*.

But man in countries that have undergone the post-communist transformation is no longer entirely "homo sovieticus" and is still not entirely "homo economicus." In other words, he is "homo transformativus."

"Homo transformativus" is a vigorously active person both in a legal and in a shadow economy and practically all questions of post-communist transformation should be viewed through the prism of his behavior.

The principal difference between shadow economics in countries with market systems and communist-type economies stems from the very essence of these two fundamentally different economic systems, and in particular, the prevailing forms of ownership. In communist-type countries, the shadow economy developed on the basis of state ownership, while in countries with developed market systems, it developed primarily on the basis of private, but also on the basis of state, ownership.

The process of privatization of state property in post-communist countries may become the basis for the transformation of the shadow economy that is characteristic of communist-type countries into a shadow economy that is characteristic of countries with developed market systems.

Before mass privatization began, the authorities frequently believed that in the privatization process it would be possible to invest shadow capital in legal structures undergoing privatization. Unfortunately, these expectations by no means always materialized. After shadow capital was invested in enterprises scheduled for privatization, some of these enterprises were drawn into the shadow economy.

The privatization of state-owned property is not only and not merely the act of buying and selling the latter, but is essentially a process that has pretensions to forming a social stratum of entrepreneurs.

Many of those who call themselves entrepreneurs in post-communist countries are former party figures and former directors in whose behavior it is very difficult to find the merits "possessed" by "Western"-type entrepreneurs.

But the majority of those in charge of enterprises today behave just as they did before when they were appointed directors of state-owned enterprises. To date, work methods like padding or other distortions of financial accountability, the production of inferior, substandard products, theft on the job, bribe-taking, and so on, have not been eradicated. Today, too, they try to live at state expense: they are becoming parliamentarians, "forcing their way" into the government or pushing their people forward so the state will pass laws and other legislative acts that will enable them to reap any economic gains at the expense of any "sacrifices" of the interests of individual citizens and all society.

Before the post-communist transformation began, persons in this cate-

gory were called "*deltsy*" While the direct English translation of the word "*delets*" is "businessman," they have little in common, which is obvious when we compare the behavior of the "*delets*" and the "businessman." It is therefore much better not to translate "*delets*" but to leave it in Russian.

Returning to the aforementioned, it may be concluded that in the initial stage of the post-communist transformation the "*delets*" could by no means always be transformed into an "entrepreneur." The "*delets*," as one of the representatives of "*homo transformaticus*," took on market-democratic forms albeit remaining essentially the same. Therefore, it is more accurate to call entrepreneurs who emerged in countries undergoing post-communist transformation "*post-deltsy*."

The "post-*delets*" phenomenon is one of the principal keys to understanding many problems of post-communist transformation, including the transformation of the shadow economy.

The most "inoffensive" of the part of the shadow economy in communist-type countries was the "second" economy. Following the collapse of the communist-type economy, almost all small business, which was also the basis of the "second" economy, was left in the shade. While in the past representatives of the "second" economy did not register officially because of discriminatory taxation and a sense of fear, they are now prevented from doing so by racketeering and corruption in the registration process.

In the majority of the post-communist countries the informal economy should have disappeared with the abolition of centralized planning. Unfortunately, it still remains, albeit in modified form. If heads of state enterprises in the past tried to lower the state plan so as to be able to overfulfil it, at the present time, heads of private enterprises (they are for the most part the same people) try to officially reduce the volume of production so as not to pay taxes: in their official reports, they reflect only a small part of their output.

These "post-*deltsy*" do not hide from the public. To the contrary, they often voice demands for the creation of favorable conditions for their work in the mass media. These voices are often heard *inter alia* in the higher echelons of state government.

The lobbying of decisions advantageous to the "post-*deltsy*" in the legislative and executive branches has become commonplace.

The name "businessman" no longer applies to many "post-*deltsy*" and, as already noted, they are trying to bolster their influence in the political arena to be the "chosen ones of the people" in the highest legislative body. Thus, the probability that parliamentarians in the post-communist countries will be gripped by the "roots" of the shadow economy is very high.

In the economics of the post-communist transformation, the so-called



gentleman's agreement has acquired large scope. Economic agents try to downplay quantity and the price of the product in a contract or to steer clear of contracts altogether. Clearing transactions were carried out exclusively with cash.

We should discuss smuggling in particular. It should not be thought that smuggling was totally nonexistent in communist-type countries when the state border and the customs service were at a high level; it existed, but it was of a primarily political or purely criminal (drugs, arms) nature. In countries that have undergone the post-communist transformation, contraband also includes ordinary commercial goods. These goods are contraband only because they cross the border without customs being paid for them. However, in the majority of instances, this does not mean that smugglers pay nothing: customs officials accept bribes from them for their "services."

The fictitious economy also remains in force, although the mechanism of its functioning has undergone fundamental change. While in the past, "deltsy" artificially increased the pay of their workers or hired fictitious workers, dividing pay increases in the former instance and pocketing all pay in the latter, the official wage in almost all commercial structures today is several times lower than the sum actually paid or workers' employment is not formalized at all, that is, officially, they receive no pay whatsoever. Both employers and workers benefit from this arrangement. The former pay the state almost no social withholdings—they are charged against the wage fund—while the latter pay no income tax or pay only a meager part of it.

The "post-deltsy" and their successors have not forgotten the art of producing inferior, substandard, and even unsafe products. By offering these pseudoproducts for lower prices, they capture considerable segments of the market and receive significant incomes, to the detriment of consumers' interests.

"Post-deltsy" demand state assistance, citing too many reasons: we are now getting enterprises back on their feet; as a result of severed economic ties, we cannot sell our products; the government, acting "under the dictates" of the International Monetary Fund and the World Bank, has allowed foreign capitalists to scorch domestic markets, and so forth.

The "post-deltsy" indeed proved to be unready to work under the new conditions. They did not understand that on the same counter next to inferior and high-priced goods there can be goods that are priced the same or lower and of much higher quality. In order to be victorious in the competitive struggle, they must either lower prices and improve quality of goods produced or else erect a "Great Wall of China" against their competitors. Unfortunately, very few post-communist businessmen think about the first path. It is much easier to persuade the authorities to pursue a strong protec-

tionist policy, thereby restricting competition on the part of foreign producers. The "patriotism" of the "post-deltsy" and their followers bodes significant losses in the level of well-being of the citizens of post-communist countries.

One type of state support for domestic production in all countries including post-communist countries is state purchases. Here, too, the "post-deltsy" have found a "loophole" for their "shady" plans, naturally not without the help of state officials. The transaction is simple: the state buys the products of a given enterprise for artificially inflated prices, and this increase in price is "divided" between participants in the transaction.

A number of post-communist countries entering the transitional economy are preserving types of shadow activity, such as the thefts of materials, resources, and other means of production. If some kind of explanation can be found with respect to state enterprises that have not yet been privatized, the situation in which the enterprise owner himself steals his own property seems paradoxical. This is done so that products can be produced "on the side" and will be left out of the reckoning. Thus, to the "post-delets" way of thinking, one of the principal ways of earning money continues to be theft, even of ones own property.

Many enterprises continue to work using resources accumulated earlier in excess of the norm. It should hardly be considered that the "deltsy" knew that in principle the end of a communist-type economy was possible, but if these enterprises also work, then this would be at the expense of the recent "shadow" activity of "deltsy."

The formation of new independent states reveals the need to form new economic institutions of statehood and to pursue appropriate economic policy. In the process, it frequently becomes possible for "post-deltsy" to earn illegal money. This is graphically exemplified by the licensing and establishment of quotas for export-import transactions. It is generally recognized that some goods and services (especially arms, drugs, etc.) should be produced and delivered under strictest state control, but there is no economic substantiation for controlling exports and imports of conventional goods, and, most important, this creates favorable soil for corruption and extortion.

In the period of post-communist transformation, the state quite often meets the newly made businessmen half way, offering various benefits, especially in the area of taxation. This step directly promotes the emergence of shadow activity.

Obviously, the state cannot grant benefits to everyone, lest it be left without means to exist. Therefore only a very limited group of people enjoy these benefits. Let us assume that the authorities have decided to extend tax privileges to a particular firm. Losses in state budget revenues must not be

high. However, after the privileges have been introduced, the "post-deltsy" try to extend these benefits to any activity, and as a result of underground deals, virtually the entire economy is swallowed up in this "hole."

The most complex part of the shadow economy remains the "black" economy.

It must be noted that, despite the possibility of legalizing their activity, the majority of "black," unofficial enterprises found themselves in a difficult situation; many of them simply ceased to exist, which once again demonstrated the inability of the "post-deltsy" to work without state support, when resources were centrally distributed.

After the communist-type economy collapsed, there was a major chance for goods produced in the "black" economy to emerge from the "shade." However, at the beginning of post-communist economic reforms, stores in many countries were almost entirely bare. If only one part of trade (trade in scarce, primarily imported products) had hitherto been part of the "black" market, with the beginning of the reforms, the entire market became "black." So-called merchandise markets, where practically everything could be purchased, were legalized, but almost no one officially paid taxes.

Nor do large trade facilities that have either already been privatized or that are in the process of being privatized "relinquish" their positions. They continue to carry on both official and unofficial trade. But if there were previously only goods of a certain list price on the counter and everything else was sold under the counter (at higher prices), in the initial stage of the reforms, absolutely all goods were on the counter even though some of them were not registered. There are cases when products produced "on the side" sell for lower than officially registered prices.

- Due to the lack of a corresponding legislative base and with the tacit consent of the authorities, some post-communist countries have created private companies, which, according to the "pyramid" principle, attracted the population's money (interest was paid to investors from newly attracted money). After pocketing large sums of money, the heads of these companies either fled the country or landed in prison. As regards financial responsibility to the numerous investors, in some post-communist countries it had to be assumed by the state.

One of the "novelties" of the economy undergoing transformation was a return to cash money. The reason for this was not only tax evasion but also interruptions in the work of banks when ordinary remittances of money were earned out with long time delays. Therefore, many who had money in their bank accounts prefer to revive their money and pay with cash that they carry in their suitcases. Demand emerges for cash money, and together with it there is new, highly profitable "business" in converting bank money to cash on the basis of the bribery mechanism.

One more novelty appeared in the development of the shadow economy: free economic zones. By design, the free economic zone was intended to attract progressive technologies with the aim of promoting economic growth in a certain region of the nation. Unfortunately, it was specifically the free economic zones that accounted for the majority of international financial crimes. In many post-communist countries, the largest flow of "shadow" money from virtually the entire world passes through companies registered in free economic zones for its subsequent legalization.

In some post-communist countries, in observance of "social fairness," privatization vouchers were issued to the population. Due to a lack of appropriate institutions, the great majority of the vouchers ended up in the hands of the shadow persons, who were thereby able to control the supply of and demand for vouchers and hence their prices.

In many post-communist countries, where voucher privatization was carried out on the "black" market, vouchers were purchased from the population for a price that was several times lower than the nominal price. Therefore, many times more former state property ended up in the hands of shadow persons than they could acquire for its nominal value; the share proclaimed by the state of the entire population in privatized property was concentrated in the hands of crafty shadow speculators who paid no taxes.

In summary, it may be concluded that the problems of the shadow (and not only the shadow) economy in post-communist countries are primarily connected with the lack of some market FIs and the weakness of others already in existence. Therefore, the creation and strengthening of FIs seem to be the top-priority tasks of the post\*communist transformation.

## Notes

1. For example, B. Svenson, *Ekotiomicheskaiaprestupnosf*. Moscow: Progress, 1987.
2. D.W. Adams and D.A. Fitchett, eds., *Informal Finance in Low-Income Countries*. Boulder, CO: Westview Press, 1992.
3. For example, A.N. Shokhin, *Sotsial'nye problemypetvstroiki*. Moscow: Kkonomika, 1989, pp. 57-83; *Tenevaia ekonomika* Moscow: Ekonomika, 1991.
4. In the history of mankind, various models of socialism are known: "fascist," "Swedish," or "Islamic." Differing radically from these is the model that was cultivated in the former USSR, in the former countries of Eastern Europe, and in certain Asian countries (China, Mongolia, Korean People's Democratic Republic, and the Socialist Republic of Vietnam); their distinguishing feature is that to one degree or another they had a communist orientation. For the sake of clarity and brevity, we shall call these countries communist-type countries.
5. D. Nort [North], "Institutsional'nye izmeneniia; ramki analiza," *Voprosy ekonomiki*, 1997, no. 3, pp.6-17.
6. V. Kuznetsnov, "K teorii perekhodnoi ekonomiki," *Mirovaia ekonomika i mezhdunaradnye otnosheniia*, 1994, no. 12, p. 8.

7. V. Papava, " 'Social Promotion\* of Economic Reform in Georgia," *Economic Systems*, 1996. vol. 20. no. 4, pp. 305-14.
8. I. Ékes, "The Hidden Economy and Income: Hungarian Experience," *Economic Systems*, 1994, vol. 18, no. 4. pp. 309-34.
9. B. Svenscm, *Ekonomicheskaiia prestupnost'*. pp. 92-95.
10. V.G. Papava, "O vozmozhnosti funktsionirovaniia obshchestvennogo sektora po printsipam chastnogo (aspekt nalogooblozheniia). *Ekonomika i matematicheskie metody*, 1996. vol. 32. no. 4.
11. B. Svenson, *Ekonomicheskaiia presiupnost* pp. 63-64.
12. A.N. Shokhin, *Sotsial'nye problemyperestroiki*, pp. 69-83.
13. V.G. Papava and R.O- Akhmeteli, *Gruziiia na puti k ekonomicheskoi samostoiatel'nosti*. Tbilisi: Metsmereba, 1990. pp. 67-69.
14. V.S. Avtonomov. "Model' cheloveka v burzhuaznoi politicheskoi ekonomii ot Smita do Marshala," in *Istoki: Voprosy istorii narodnogo khoziaistva i ektmomichesktri mysli*. Vol. 1. Moscow: Ekonomika, 1989; V.S. Avtonomov, "Poisk novykh reshenii (model'cheloveka v zapadnoi ekonomicheskoi teorii 1900-1920-kh godov)," in *Istoki: Voprosy istorii narodnogo khoziaistva i ekonomicheskoi mysli*. Vol. 2. Moscow: Ekonomika, 1990.
15. G.P. Brockway, *Tlie End of Economic Man*. New York: W.W. Norton and Co., 1995.
16. F. Hahn, *Equilibrium and Macroeconomics*. Cambridge, MA: MIT Press, 1984, p. 68.
17. E. Kochetov, "Neockonomika: novaia tsivilizatsionnaia model\* ekonomicheskogo razviuia," *Mirovaia ekonomika i mezhdunarodnye otnosheniia*, 1997, no. 3, p. 82.
18. V. Kuznetsov, *K teorii perekhodnoi ekonomiki*, p. 8.
19. Institutional man can be regarded as "contract man" (see O.I. Uil'iamson [O.E. Williamson], *Ekonomicheshe instituty kapitatzizma: Firmy, rynh, "otnoshencheskaia" kontraktatsiia*. St. Petersburg: Unizdat, CEV Press, 1996, chapter 2).
20. V. Papava, "The Georgian Economy: From 'Shock Therapy' to 'Social Promotion,' " *Communist Economies and Economic Transformation*, 1996, vol. 8, no.2, pp. 260-62.
21. They are frequently called "red directors."
22. This privatization method is, by nature, communistic and has nothing in common with a market economy (see: V. Papava, "O privatizatsii osnovnykh faktorov proizvodstva," *Pravila igry*, 1992, no. 3; V. Papava, "Marxist Points of View on the Soviet Communist Economic System and the Manifestation of Egalitarianism in Post-Communist Economic Reform," *International Journal of Social Economics*, 1995, vol. 22, no. 6.