CHAPTER FOUR

Transition and the Road to the Inequality Trap

What keeps a man alive?

What keeps a man alive? He lives on others.

He likes to taste them first then eat them whole if he can.

Forgets that they're supposed to be his brothers,

That he himself was ever called a man.

Remember if you wish to stay alive

For once do something bad and you'll survive.

From "How to Survive," Berthold Brecht and Kurt Weill, *The Threepenny Opera*[1]

When Bo Rothstein (2000, 479) was invited to Moscow to lecture about the Swedish civil service, a Russian bureaucrat asked him: "'How do you go from a situation such as Russia's to the situation which exists in Sweden?' That is, how do you move a society (or an organization) from a low trust situation with massive tax fraud and corruption to a high trust situation where these problems, while still in existence, are much less severe?"

Is there a way out of this misrule, this lawlessness, and low trust? The inequality trap suggests not. Yet, Russia and other countries that made the transition from Communism to democracy–in Central and Eastern Europe and in the former Soviet Union--are the major exception to my argument linking high inequality through low generalized trust to much corruption. Yes, they have high levels of corruption–former and the handful of still Communist countries on average are more corrupt than either the West (by far) or the developing nations. And yes, they have low levels of trust– slightly higher than developing countries but much lower than the West. Yet, they have on average *the lowest levels of inequality*–marginally less than the West but far lower levels than developing countries.[2] In the aggregate model testing the inequality trap, I included a dummy variable for transition countries since they had high levels of corruption *and largely did not fit the overall model.*

So will transition countries escape the inequality trap? Alas, no. The fall of socialism and totalitarianism did not mean the emergence of well ordered states with strong markets layered on top of the already existing egalitarian distribution of wealth. New democratic institutions did not ensure smoothly functioning states and reduced corruption. Parliamentary elections and promises of the rule of law did not turn Romania or Russia into Sweden (Uslaner and Badescu, 2004). The march to market democracy has been a mixed success: Most formerly Communist countries had free elections and freedom of speech, but virtually all had to confront two troubling consequences of transition: **rising, sometimes sharply increasing, inequality and greater corruption.** The distinctiveness of the transition countries becomes less compelling when: (1) they are compared among themselves, rather than with other nations, especially the West; (2) when considering more recent data on inequality, which has been rising significantly in most former Communist countries; and (3) when I examine survey evidence about *how people think about corruption and inequality*. I take up trend data in this chapter, focusing only on transition countries and survey data in the two chapters to follow.

A decade and a half after the Berlin Wall fell and Communist governments throughout Central and Eastern Europe and in the former Soviet Union crumbled with it, the transition to democracy remains very much a work in progress. In some countries the transition has worked well. You can walk down the streets of Budapest and Prague and see little evidence of the Communist past in the expensive boutiques and the elegant older buildings. Yet, you can also drive through rural Transylvania and pass Roma women sitting on the side of highways peddling doilies; their husbands and children tug their produce to market in carts pulled by donkeys. You can walk through the streets of Belgrade and see bombed out government buildings from the United States attacks in 1999 to stop the genocide in Kosovo and take a turn around any corner to see crumbling Communist era cement apartment buildings. You take the Metro in Novosobirsk, Siberia and put your hands over your face so as not to breathe the gasoline fumes from the trains.

There is another side to both stories. You can dine well at the new fancy restaurants in the "big city" of Cluj-Napoca, Romania. The pedestrian mall in Belgrade sells wide screen Sony LCD television sets and the gourmet supermarket in Novosobirsk offers cans of Japanese beer for $5 each as well as all manner of attractively presented imported foods.

As some people prospered in the capitalist economy and could afford to buy the fancy goods in the Gianni Versace, Givenchy, and Burberry boutiques, many more could not keep up with the new economy where jobs were no longer guaranteed for life. Many people were forced into the informal economy, where they earned less than in state enterprises and had no legal protection against exploitation by corrupt employers. In China, making the transition to capitalism if not to democracy, you can buy three scoops of the American gourmet ice cream Haagen Dazs for $6.50 two blocks away from Beijing's Tiananmen Square, home of the Great Hall of the People: The ice cream parlor is right next to the Rolex store and around the corner from the Rolls Royce dealership. A fifteen minute walk away from the main square that same

$6.50 will buy you a pair of shoes.

Even the “success stories” struggle with the legacies of the past. As much as Budapest and Prague may resemble Vienna, Hungarian politics is wracked by ethnic conflicts. Two days before the 2006 Prague parliamentary elections, the opposition party (leading in many polls) charged the leaders of the governing party with blocking an investigation of a murdered business executive who reputedly collaborated with state officials and the Mafia in defrauding the state energy company (among other alleged crimes).[3] The governing party did not suffer major losses and the Czech anti-corruption party (whose rally and leader are pictured on the cover) received 2.6 percent of the vote and no seats in the Parliament.

Democracy is not a cure-all, argues Mueller (2001). But, then, neither is his preferred route to success, the market. Almost all transition states became *more* corrupt as they became democratic. And almost all transition states saw sharp rises in economic inequality over the past decade and a half.

This chapter is about the rise of the inequality trap in transition countries, in societies where inequality ranked very low on the list of problems in Communist societies. Increasing inequality may not be the only problem in transition countries, but it is the source of grievances on other issues. The market economy forces many people into the informal sector, where they earn at best subsistence wages and have no legal protection. The “owners” of the informal economy have no legal protection either, but they have the resources to bribe public officials not to interfere with their businesses and to evade taxes and other regulations, making them even richer. Many people felt cheated by the transition–and repeated double-crossing is a signpost of unequal wealth and power (Howard, 2003, 29).

People in transition countries see a clear link between corruption and inequality. As Anderson et al. (2001, 25) argue:

> The poor often blame the government for their impoverishment and report widespread corruption and helplessness. In Georgia, poor farmers equate privatization with theft and complain that the best land is distributed to those who work for the police, courts, school directors, and business people. In Moldova poor people equate independence, democracy, and the transition to market with lack of social justice. Workers on collective farms report being cheated out of their share of grains and denied access to equipment by those in control.

Jack Blum, who formerly worked for the Senate Foreign Relations Committee, commented on a multimillion scandal in Kazakhstan involving an American consultant, multinational oil companies, and many Kazakh officials, reportedly including President Nurultan A. Nazarbayev: "Corruption is at the heart of what causes poverty in third world countries. We tell ourselves that in the short term, we can buy these guys who will serve the national interest, but in the long run it always turns into a disaster" (Stodghill, 2006, BU9). Former Kazakh Prime Minister Akezhan Kazhegeldin said of corruption: "There is a small group of people getting rich - and I mean really rich - in Kazakhstan while the rest of society remains really poor. The leadership is not interested in pushing a market economy. They keep two sets of books, one for themselves and another for everyone else" (Stodghill, 2006, BU9).

The great promises of market democracy are democracy, equal justice under the law, and opportunities for prosperity and access to the material goods that were denied to all but the elite under Communism. Both justice and prosperity are still distributed unequally–and people with less will naturally envy those with much more, especially in societies where economic equality was a central tenet of official ideology. The rapid and often steep rise in inequality underlies many of the problems that people see in their transition nations.

Corruption and inequality are the talk of most transition countries. People see them as the biggest obstacles to making the grade in transition. They speak of corruption and inequality as if they were two sides of the same coin, as if the inequality trap were something distinctive to former (and present, in the case of China) Communist regimes, rather than seeing themselves as the exception to the larger pattern. As inequality and corruption have both grown, ordinary people look at wealthy people and are convinced that they must be corrupt. Much of the time, they are right. But even when they aren't, those who have not fared well from transition look with envy upon the consumer goods and fancy cars and the flouting of the law by people who have become rich.

Communist economies could not deliver the goods, so people had to use whatever means they could to get by–and petty corruption was at the top of the list. Party and government leaders and their close associates did not live by the same rules as everyone else, so grand corruption flourished as well. There were few people at the top, so the economic statistics showed very modest levels of inequality. The advent of capitalism widened the gap between the newly rich and the poor. For many countries, the result was a vicious circle entwined in the low trust among people that was the hallmark of the Communist regimes, in brief, the inequality trap.

Part of the inequality trap is an unfair legal system and the former (and present) Communist countries score poorly on legal fairness, though slightly better than developing nations.[4] On average, 42 percent of people in transition countries believe that their court system was not fair–ranging from 28 percent in Estonia to 68 percent in Georgia.[5] Totalitarian systems were based upon eternal vigilance against enemies of the regime and their secret police intimidated people to testify against their acquaintances, their friends and even their families. This system of legal repression took especially high tolls on people who have no friends in high places, who are otherwise powerless, making the legal system not only brutal but also unfair. It also makes trusting anyone beyond your closest friends and family hazardous–and irrational. What ties developed are intensely personal. Trusting strangers involves a leap of faith that was too dangerous in Communist regimes.

Rothstein suggested that Russians could reduce corruption and build trust by creating a stronger legal system, but the Russians have seemingly paid him little heed. In 2005 over 1400 "takeover artists" seized control of Russian private businesses, owned by locals and foreigners alike, by forging sales agreements, voting out the rightful owners, and often using violence to take over factories. By either bribing authorities or stealing the ownership documents, these con men are outside the reach of the law (Kramer, 2006). Starbucks, Kodak, Forbes, Audi, and the H&M clothing chain have all been the targets of trademark "squatters," who have registered the company names and extort up to $60,000 from the rightful owners to reclaim their brands as the courts stand idly by. The Starbucks brand name was far more coveted, with an asking price of $600,000 (Kramer, 2005, C1, C4).

Many ordinary people still face a justice system biased against them. A Russian court convicted a railway worker in a closed trial in 2006 after his car was hit from behind by a vehicle carrying one of the country's most prominent politicians, causing an accident that ended in the death of the official. The court ruled that the worker should have seen the leader's car coming and sentenced the worker to four years hard labor, provoking widespread protests (Finn, 2006). Russia is hardly unique: Poor people in China who challenge government policy and their attorneys are regularly jailed and denied counselors who would argue on their behalf (Fan, 2006; Kahn, 2005).

The growing economic inequality across transition countries gives people little reason to be optimistic for the future–much less to believe that they are the masters of their own fate, two of the most critical determinants of generalized trust. Many of the totalitarian regimes also prohibited long-standing ethnic tensions from coming to the fore. Democracy gave voice to these conflicts, sometimes violently (as in Bosnia, Serbia, Croatia, Armenia, Azerbaijan, Macedonia, and Russia) and sometimes in a political party system based upon ethnic ties (Hungary, Romania, Bulgaria, Ukraine). These ethnic conflicts reinforced the low level of generalized trust in former Communist states. They were not simply issues of identity, but of control over land and of the distribution of wealth: Present and former Communist countries have much higher levels of uneven economic development than we see in the West (an average score of 6.64 out of 10 compared to 4.1 for the West).[6]

My primary task in this chapter is to examine aggregate evidence on the increases in inequality and corruption in transition nations and to show how they are related to each other–to demonstrate that the aggregate linkages from inequality, both economic and legal, to low trust to high corruption hold for transition countries as well. I could not demonstrate this with the model in Chapter 3 because I needed to use measures of economic inequality (from the World Bank) that are clearly comparable to each other. Because of the salience of rising inequality in transition countries, there are multiple measures of wealth distribution in transition countries that permit me to track changes over time and for more transition countries than are in the cross-national data sets.

I shall present aggregate analyses of the consequences of inequality among countries in transition in Central and Eastern Europe and the former Soviet Union in this chapter. However, there are only 27 transition countries and the availability of data for my desired measures is often sparse, so most of these analyses (mostly confined to simple graphs) may not be conclusive.

I will offer three multivariate models of corruption, inequality change, and the change in the Communist vote, recognizing that they are based upon small samples. Nevertheless, they support my argument of an inequality trap with data from countries where economic inequality has historically not been a major issue.

Inequality and an unfair legal system are key determinants of corruption–but there is hope as well. Wealth and an open economy also lead to less corruption, so a country's fate may be somewhat more optimistic than first thought. Inequality in turn stems from corruption, a growing informal economy, and a general sense of disorder (street crime)–though democracy does lead to greater equality. Inequality, corruption, and a weak legal system all lead to higher shares of voting for the Communist party–the natural enemy of the reconstructed market economy and perhaps of democracy itself. They are also key determinants of state failure and the interruption of public services (using both the Failed States and BEEPS data sets). In most of the analyses I consider changes in inequality, rather than (or in addition to) the absolute levels of inequality. Rising inequality may make people even more disappointed with transition than the actual amount of inequity, since it gives them little reason to be optimistic over the longer run.

Next I turn to both individual-level analyses (including some hierarchical models) and aggregate regressions on business practices, service delivery, and gift payments in transition countries using the 2005 Business Environment and Enterprise Performance Survey (BEEPS) of the European Bank for Reconstruction and Development and the World Bank.. BEEPS 2005 is a survey of business people in 26 transition countries (all except Turkmenistan).[7] I investigate the effects of inequality and generalized trust on the shares of business sales on credit at both the individual and aggregate level.

Raiser, Rousso, and Steves (2004) argue that the share of sales on credit is a good proxy for trust in economies where people have long had little faith in strangers–and just as little experience in extending credit. Both mistrust and corruption, in a hierarchical model, and perceptions of corruption and the lack of a respect for law, lead business people to deny credit to strangers. So do strong in-group ties, but a willingness to engage in organizations with other business people promotes selling on credit. At the aggregate level, corruption and inequality both lead to less reliance on credit. Increasing inequality and a corrupt legal system lead to more gift payments in a wide range of business dealings, but strong financial regulations can overcome some of the demands for bribes. Increasing inequality, corruption, and weak legal systems all have deleterious effects on perceived service delivery for water supply, phone service, and power outages.

The story of the aggregate analyses is straightforward: Inequality matters in a region where it has historically not been seen as a critical problem. It leads to more corruption, a greater willingness to vote for the Communist party (and hence to restrict the market), to mistrust in business (as reflected in sales on credit), to more demands for gift payments by business people, and to problems in the delivery of basic services. The transition countries are not immune from the inequality trap. The situation is not completely dire. In most cases, policy choices or institutional design can mediate the negative effects of inequality and corruption. Yet, they are not sufficient to overcome the trap completely. Institutions such as democratic government matter too, but the trap seems inescapable.

The Inequality Trap and the Transition from Communism

Under Communism, all people (animals) were equal, George Orwell (1946, 123) wrote in Animal Farm, though some were more equal than others. This "equality" meant that most people faced the same problems of scarcity of goods and had to resort to informal connections–petty corruption–to get by in daily life–to stand in line for food, to help run errands, or to use a friend or relative to cut through the bureaucracy--was common practice under Communism (Flap and Voelker, 2003; Ledeneva, 1998). In Romania the system was called *pila.* It was so pervasive in Russia that, like snow for northern peoples, it had multiple names: *blat* (pull), *pomochi* (mutual aid), *sviazy* and *znakomstvo* (connections), and *protektsiia* (patronage) (DiFrancesco and Gitelman, 1984, 603; Hosking, 2004, 52).

These techniques of mutual assistance were essential to getting by in a system where everything was in short supply. Bureaucrats' control over scarce goods and their freedom to treat people arbitrarily and with abuse gave them considerable power over ordinary people–and this power translated into demands for bribes for every manner of goods and services. Sixty-four percent of Soviet citizens who emigrated to Israel, West Germany, and the United States in the late 1970s through 1980 held that having connections was the best way to get things done; 46 percent said that they would offer a bribe as a matter of *first* resort if a public official lied to them or refused to give them their due (DiFrancesco and Gitelman, 1984, 611).

People see the bureaucratic system as stacked against them and see few alternatives to paying bribes or using connections: "the average citizen is without influence over policy-making and has little legal protection against administrative arbitrariness or even the mindless application of what is construed as the law. He is left to devise individual strategies and tactics, which will not change the making of the law, but will, he hopes, turn its implementation in his favor. Each person, then, is reduced to being a special pleader, and not with those who make the rules but with those who are charged with applying and enforcing them" (DiFrancesco and Gitelman, 1984, 618).

Communist countries had less inequality based upon official data (which may not have been measured or reported with precision) than the West or developing nations.[8] Yet, this statistical inequality hid the great wealth of a handful of officials at the top, the *nomenclatura* in Russian, who had privileges unavailable to ordinary citizens–and who used their state positions to enrich their private lives. Communist countries were filled with corrupt officials, even as they preached equality and kept the overwhelming share of their populations poor. There were perpetual shortages because of the centralized means of production, but also because the imbalance of demand and supply and the large bureaucracy provided many opportunities for extortion.

Communist regimes rested upon unwritten rules rather than legal fairness. Rules were always open to interpretation–thus providing opportunities for officials to blackmail and intimidate ordinary citizens (Ledeneva, 2005, 9). Corrupt officials were mostly immune from charges of malfeasance, since they were part of the same state apparatus as the courts. Communism also rested upon a "culture of dependency and low levels of initiative," which provided fertile grounds for corruption. So did the fuzzy dividing line between what was public and what was private and the high level of secrecy (Holmes, 2006, 183-185).

The transition to democracy that began in 1989, especially with the fall of the Berlin Wall, and culminated with the demise of the Soviet Union in 1991 was one of the most striking transformations in centuries. Democratic institutions took hold: Political parties bloomed–in some countries such as Romania and Poland the number of parties right after the transition was dizzying large: more than 200 in Romania and over 100 in Poland.

The transition raised both hopes and expectations for millions of people (Howard, 2003, 136-140; Sztompka, 1999, 160; Vasecka, 1999, ch. 2, 7). Yet, six years later, when Rothstein visited Moscow, government officials and the public alike still saw the society as plagued by corruption, tax evasion, an unfair legal system, and low trust. Perhaps above all, it was less equal.

In 2006, almost all of the countries in Central and Eastern Europe as well as Estonia, Latvia, and Lithuania had become "developed democracies," accordi ng to the Bertelsmann Transformation Index (Bertelsmann Stiftung, 2006, 234-235), although some countries, especially the Asian nations formerly part of the Soviet Union, lagged behind. People throughout transition countries presumed that democratic government and markets would transform former Communist nations into modern market democracies, complete with the rule of law and economic prosperity (Sztompka, 1999, 179). When this did not occur immediately, optimism gave way to disappointment.

The disappointments of transition reflected much more than unrealistic expectations.

The end of the all-powerful state meant "shock therapy" for many ordinary workers, who lost their guaranteed jobs and had to find their own way in economies with few opportunities. State enterprises hired far too many people and their private successors could not afford such large work forces. As many people struggled to find alternative employment–often in the informal economy–corruption persisted. Dishonesty became more prevalent as former Communist party members were often able to secure control of the privatized companies at a fraction of their market value–and with few legal checks on how they ran their businesses (Johnston, 2005, 196). Many of the old bosses were still around–and they seemed to be among the few who really prospered in the new order. For many, the authoritarian regime was thankfully gone, but in its place was a free-for-all grab for money and power marked by "uncertainty and devoid of moral guidance" so that "people feel isolated and lonely, and turn their resentments against others" (Sztompka, 1999, 174).

Transition country publics see wealth as a sign of strong connections and especially of dishonesty. While most Westerners believe that the path to wealth stems from hard work, 80 percent of Bulgarians, Hungarians, and Russians say that high incomes reflect dishonesty (Kluegel and Mason, 2000a, 167; cf. Orkeny, 2000, 109). Even in countries such as Estonia, Slovenia, Slovakia, and Poland–the "success stories" among transition countries, ordinary people expressed suspicion of how people became rich in the early 1990s. By later in the decade, such feelings had subsided in countries where people were doing well (especially in the Czech Republic), but became more intense where inequality had increased (Orkeny and Szejelyi, 2000, 208).

Mateju (1997, 4-5) argues:

> ...the long-lasting presence of an egalitarian socialist ideology and a functioning "nomenclatura system" associated with various social and economic privileges mean that those countries undergoing the post-communist transformation will show a low tolerance for the growth of inequality...individuals who feel that life-chances for their group or class are declining in relation to those of other groups or classes may tend to consider such changers as the result of social injustice...

Stoyanov et al. (2000, 35) report survey data on Bulgaria showing that:

> the reasons for being wealthy...have to do mainly with the unfair social system ensuring better opportunities for the 'well connected' and the unscrupulous....the negative image of wealthy people does not represent only the communist socialization stereotype, but results also from recent...experiences of corruption, organized crime, and "illegal" wealth.

People in transition were substantially less likely to believe that "people get what they need" and that "people have equal opportunities to get ahead" than Western publics (Orkeny and Szejelyi, 2000, 206).

In the 1999 International Social Survey Programme (ISSP), focusing on inequality, 51.8 percent of the respondents in the nine transition countries surveyed believed that to get to the top, you must be corrupt, compared to 28.3 percent on average in the other 18 countries (mostly Western democracies).[9] Perceptions linking inequality to corrupt behavior are particularly severe in countries where corruption is most severe, both in the handful of transition countries in the sample and in the full set of countries in the ISSP sample. Eighty-one percent of Russians and 68 percent of Bulgarians agree, compared to 32 percent of Hungarians and 39 percent of Czechs.

These perceptions also strongly track inequality and especially changes in inequality in the transition countries but *not* in other nations.[10]

Even though the World Bank Gini index is 25 percent lower for the transition countries, people in those nations see far more inequality than those in other countries: 39 percent say that it is important to come from a wealthy family to succeed (compared to 29 percent elsewhere). Only 18 percent (compared to 25 percent) say that income differences are necessary for a country's prosperity, while 93 percent (compared to 78 percent) say that income differences are too large. People in transition countries are more likely (by 63 to 57 percent) to see a conflict between the top and bottom rungs of society and by an even larger margin (55.1 to 42.6 percent) to see a struggle between the rich and the poor. Eighty percent (compared to 63 percent) believe that government has a responsibility to reduce income gaps–which is hardly surprising since few people believe that people get rewarded for their skills and intelligence (20.5 percent compared to 50.4 percent elsewhere) or especially the efforts they expend (13.6 percent versus 42.3 percent). Western respondents see far less economic inequality and far greater opportunities for advancement through one's own efforts. People in transition countries see far more inequity and link it to corruption.

When Russian entrepreneur Mikhail Khodorkovsky confessed his sins of relying on "beeznissmeny" (stealing, lying, and sometimes killing) and promised to become scrupulously honest in early 2003, Russians regarded this pledge as "startling." When he was arrested and charged with tax evasion and extortion under orders from President Vladimir Putin ten months later, the average Russian was unphased: About the same share of people approved of his arrest as disapproved of it (Schmemann, 2003; Tavernise, 2003). People not only see a connection between corruption and wealth, but they believe that rising inequality has its roots in corruption.

The strong arm of the state, the perception of an unfair legal system, and of unequal access to basic consumer goods made generalized trust a scarce commodity in Communist countries. Yes, there were social networks in Communist states. They were not the "bridging" ties that connect us to people who are different from ourselves. Instead, they consisted of two types of connections that either substituted for wider ties–families and intimate friends–or that may even have inhibited generalized trust–purely instrumental networks that existed " to secure resources from state authorities, which controlled everything from political life to personal careers to food and housing" (Rutland, 2005, 9-10; Howard, 2003, 27-28).

The helping networks that played such a key role in the Communist regimes were *substitutes* for the wider social networks that were simply not possible under repressive governments (Flap and Voelker 2003; Gibson 2001; Ledeneva 1998, ch. 5). The responsibility of people to help each other subsistence led to a strong sense of particularized trust within the group–a distinction between us (*svol)* and them (*chuzhie)* in Russia. Ledeneva (2004, 85-86) argues: "Personal networks undermine formal institutions and thus damage impersonal systems of trust." These mutual aid networks are based upon a notion of solidarity, *krugovaya poruka* or *pomochi* in Russian, where people assume a sense of collective responsibility for each other by a wide variety of means, including coopting (bribing) bureaucrats and police officers. They also enforce community "norms" by ensuring that people in a community do not shirk their responsibilities–or behave in a manner that some in the community find objectionable (Ledeneva, 2004, 86-87, 105; Hosking, 2004, 52).

The roots of low generalized trust include: the strong arm of the regime, the dense social networks that formed to help people get by in daily life, and the widespread perception that most government officials extorted considerable amounts of money from both ordinary citizens and from state enterprises (DiFrancesco and Gitelman, 1984, 611).

I move now to an examination of the emergence of the inequality trap in formerly Communist nations. I will first offer some descriptive graphs on the key elements of the inequality trap in transition countries and then examine how they are related to each other in simple bivariate graphs. Then I will consider both aggregate and survey evidence on the impact of inequality in transition countries.

Inequality, Social Solidarity, and the Transition to a Market Democracy

Some countries have fared better in transition than others. I shall present some evidence (preliminary because of sample sizes) that economic inequality makes transition rocky. Then I move to multivariate analyses on the determinants of corruption and inequality change –and to a consideration of the consequences of inequality.

Two different data bases tell largely the same story: The Rosser, Rossser, and Ahmed (2000) data on income distribution show an increase in economic inequality from 1989 to the mid-1990s for every country save one (Slovakia). The more recent WIDER estimates indicate substantial increases in inequality–an average change of 78 percent from 1989 to 1999–for each of 21 countries (see Figure A4-1).

The rise in inequality was accompanied by an increase in the shadow economy (Schneider, 2003). Even the best performing economies, Slovakia and the Czech Republic, had almost 20 percent of their revenue off the books. Three countries had a majority of their revenue in the informal sector (Ukraine, Azerbaijan, and Georgia) and 15 of 21 countries for which there are data have at least a third of their income in the shadow economy (see Figure A4-2). Even more distressing is that 16 of the 18 countries for which there are data experienced increases in the shadow economy of at between 10 and 42 percent; only one country (Hungary) had a (very slight) decrease while another (Slovenia) experienced no change (see Figure A4-3). Not only did inequality increase, but more people had to rely upon the informal sector.

The greater the share of the economy beyond the reach of the state, the more difficult it will be for a government to marshall the resources to gain public confidence that the state can provide essential services. And here we see part of the inequality trap: If people have no confidence that politicians can pursue policies that will lead to prosperity and economic justice, they will hide their income from the tax collectors (Uslaner, 2003b; Torgler, 2003). Overall, the average share of the shadow economy more than doubled from 1989 to 1999-2000 (from 17 percent to 38 percent) and the average increase in the Gini index of inequality was 33 percent. I shall show below that these two trends are strongly related to each other.

Corruption remains a persistent problem (see Figure A4-4). In 2004, every transition country had a higher level of corruption than *any Western country*. The 2005 scores show sharp leaps in honesty for Estonia and Slovenia (atypical for this index)–outranking Greece and Italy and tied with Israel among Western nations. However, excluding Estonia and Slovenia, the mean for East bloc countries is *lower* than for developing nations. Every one of the countries in Figure A4-5 became more corrupt from 1998 to 2004. Since the corruption figures vary from 2004 to 2005, the direction of change is not as critical as is the persistent high level of corruption in the transition countries. Even differences in some scores do not disrupt overall patterns: the correlation between the 2004 and 2005 scores for the 27 transition countries is .959.[11]

Corruption is sticky over time in transition countries, as elsewhere, though there are not sufficient cases for a meaningful comparison over time until 1998. There is only a moderate amount of consistency from 1998 to 2005 ($r^2 = .543$, N = 12), but far greater for the larger sample between 1999 and 2005 ($r^2 = .832$, N = 24). The public in transition countries sees corruption as a long-term, insoluble problem: In a 2005 survey, just eight percent of Russians held that corruption can be eliminated "if dishonest leaders are replaced with honest ones," while 26 percent hold that "Russia has always been characterized by bribery and embezzlement, and nothing can be done about it" (Popov, 2006; cf. Karklins, 2005, 59 for a more general statement on transition countries). In Chapters 5 and 6 I examine survey evidence that shows how people link inequality and corruption in Romania, Estonia, and Slovakia and find strong support for this connection–and more so among ordinary people than for elites (business people and government officials).

The increases in inequality might lead us to think about the inequality trap as something that emerged from the shock therapy of transition, disrupting the legacy of more egalitarian societies. Yet, here too, the countries that became more equal after transition had less egalitarian income distributions *before transition* : $r^2 = .592$, N = 14 using the WIDER measures for 1989 and 1999 and a more impressive .801, N = 13 for the 1999 WIDER measure and a new estimate for 1987-88 also developed at WIDER (Mikhalev, 2005). *The levels of inequality have clearly risen substantially since transition, but the foundations for the inequality trap were in place even before the fall of Communism*.

Increasing inequality and high levels of corruption are a perfect recipe for low levels of generalized trust–and Figure A4-7 shows the levels of trust for the 1995 World Values Survey.

The relatively high levels of trust in Ukraine, Serbia, Bulgaria, and Bosnia seem anomalous and perhaps reflect imperfect survey conditions after transition, be they in survey design or in translation. Nevertheless, the transition countries are less trusting–often by quite a lot–than Western nations except for two countries with their own democratic transitions (though many years earlier), Portugal and Spain, as well as France.

Inequality, corruption, and low trust go hand-in-hand with an unfair legal system. So it is not surprising that over a third of businesspeople thought that the courts were not fair in 21 of the 26 countries in the 2002 BEEPS–and that over a quarter of the respondents in every country agreed with this claim (see Figure A4-8). These figures are broadly consistent with the low rankings of transition countries compared to the West on the (imputed) Economist Intelligence Unit measure of legal fairness (see n. 4 above).

How Inequality and Corruption Matter

What are the links among inequality, corruption, the shadow economy, trust, and legal fairness? I begin with some aggregate results on how inequality matters in transition economies. I express my results simply, through graphs, because of data limitations. For some of my analyses, limited data restricts my number of cases to as few as 10, so clearly any complicated modeling is impossible.

First, corruption and inequality *are* related across transition countries. There is no way to track the relationship either at or shortly after transition since there are only a handful of nations rated on the TI scale until recently. By 1997, there is a modest relationship between inequality and corruption ($r^2 = .202$, N = 11), which increases slightly in 2004 ($r^2 = .221$, N = 15), using the WIDER inequality indicators. The Dutta-Mishra measure of inequality is more strongly related to corruption (r^2 = .349, N = 22, see Figure A4-9). There is a stronger relationship between corruption and unequal economic development (r^2 = .370, N = 27).

More telling is the relationship between corruption and *change in economic inequality* (Figure A4-10): Countries in which economic inequality has increased substantially since transition are more corrupt, though the strength of the relationship is modest. If I exclude the two "most honest" transition countries–Slovenia and Estonia–the r^2 almost doubles (to r^2 = .431, N = 19). A lowess plot (not reported) shows that the relationship is particularly pronounced for countries with relatively high levels of increments in economic inequality.

Inequality is often linked to the shadow economy and there is clear evidence for this in the transition countries (see Figures A4-11 and A4-12). The Dutta-Mishra inequality indicators (used to maximize the number of cases) are strongly related to the size of the shadow economy (r^2 = .509, N = 19): As the informal sector increases, so does economic inequality (see also the analysis in Table 4-1 below). The causal relationship might go the other way (from inequality to a larger informal sector), but the number of cases is too small to tease out which way(s) the relationship might go. However, there is clear evidence that the relationship is not spurious, since changes in the size of the shadow economy are also clearly related to changes in economic inequality (r^2 = .503, N = 16, see Figure A4-12) using the WIDER estimates for inequality.[12] As the size of the informal sector grows over time, so does the level of inequality.

The cross-sectional results (Figure A4-11) show two outliers: Uzbekistan, which has more inequality than one would expect from the size of its shadow economy, and Belarus, which has far less inequality that we might expect. Existing data do not provide much data on whether the observations for Uzbekistan are out of line, but the Dutta-Mishra estimates of inequality for

Belarus are significantly lower than those from WIDER.[13] Without these two outliers, the r^2 rises to .886.

The informal sector thrives under an unfair legal system (using the BEEPS 2002 aggregate score for "the courts are generally not fair," $r^2 = .616$, N = 21, Figure A4-13). An unfair legal system also leads to an increasing share of the economy in the informal sector since transition (Figure A4-14 , $r^2 = .580$, N =18). The tight connections between inequality and the shadow economy and the moderate connection of inequality with corruption would lead us to expect that the shadow economy would be strongly associated with corruption. Dreher and Schneider (2006) argue forcefully that the shadow economy is not simply a form of corruption. It is difficult to imagine a high level of corruption without a large informal sector. There is evidence supporting this argument in Figure A4-15, where the size of the informal sector is clearly related to the level of corruption in 2004 ($r^2 = .504$, N = 21).

Even more powerful is the relationship between the *change in the size of the shadow economy* and the level of corruption: Countries where the informal sector has grown the most have the highest levels of corruption ($r^2 = .643$, N = 18, Figure A4-16). Finally, there is also a strong relationship between the *change* in a country's level of corruption from 1998 to 2004 and the *change* in shadow economy from transition to 2000 (see Figure A4-17). This relationship is very strong ($r^2 = .659$), even though it based upon the small number of cases (10) rated by TI prior to 1999.

As with the larger sample of countries, there is a clear connection between the fairness of the legal system and corruption. Countries where businesspeople are more likely to believe that the courts are not fair have higher levels of corruption ($r^2 = .464$, N = 25; see Figure A4-18). An unfair legal system also goes hand-in-hand with economic inequality: perceptions that the courts are not fair track *increases in economic inequality* (data not shown, r^2 = .500, N = 16). Growing inequality clearly threatens both the ability to raise revenue and the perception that justice is tilted toward the rich.

Inequality, the shadow economy, an unfair legal system, and corruption form a syndrome. The missing link in the inequality trap is generalized trust. There is no aggregate connection between inequality and generalized trust (r^2 = .0006). The link between trust and corruption is also non-existent (r^2 = .001 for the 2004 TI index, .005 for the 2005 measure). This may reflect problems in some surveys or it may reflect the fact that trust was so dangerous in Communist societies that generalized trust may not mean quite the same thing as in other countries. There is some evidence that this is the case in China, where many surveys show high levels of generalized trust (Tang, 2005, 105-111). When my analysis shifts from the aggregate to the individual level (see Chapters 5 and 6), trust in Romania and Estonia is related to perceptions of both corruption and inequality.

There is a more *direct* inequality trap in the transition countries from an unequal distribution of wealth and an unfair legal system to corruption. There are not sufficient cases to test this in a model similar to that in Chapter 3. However, I present a much more truncated model in Table 4-1, where I examine the determinants of corruption in 21 transition countries. Overall, the model fares quite well (R^2 = .855) and it leads to reasons to be both optimistic and pessimistic about corruption after the fall of Communism. Economic inequality and an unfair legal system are important determinants of corruption. Moving from the lowest level of inequality (Belarus) to the highest (Georgia) leads to a shift of .84 units on the 2004 TI scale–the difference, for example, between Croatia or Poland, on the one hand, and Macedonia on the other: the.84 increment amounts to almost a 25 percent shift in the level of corruption. The impacts are substantially larger for legal fairness and especially for GDP per capita (adjusted for purchasing power parity). A growing economy and more open markets also lead to less corruption, so corruption does seem responsive to policy choices.

<u>Table 4-1 about here</u>

Getting rich seems to be a powerful–perhaps the strongest–determinant of malfeasance in Table 4-1. Can countries grow their way out of corruption? The cross-sectional evidence suggests so. Yet, as in much of life, the rich get richer and the poor get poorer. Nations faring well in 1993 were the same ones that prospered in 2000: the r^2 between the gross domestic product (Penn World Tables) in 1993 and 2000 is .871 (N = 16). *Much of the reason for the deviation from a perfect linear relationship lies in the extraordinary growth rates of countries with the lowest levels of corruption–Estonia and Slovenia.* Perhaps honest government is more essential to economic growth than wealth is to low corruption.

Growth has been highly uneven: Of the 16 transition countries for which there are data on GDP change from 1993 to 2000 in the Penn World Tables data, half showed *declines* in income since early in the transition and only Poland, Slovenia, Estonia, and Albania have experienced growth rates of more than 10 percent over eight years. Of the 26 transition countries for which there are data on GDP growth from 1990 to 2003 from the United Nations Development Program, 10 (all in the former Soviet Union) had *negative* growth rates, five grew at less than one percent, and only one at a rate more than 10 percent (Bosnia, which nevertheless remains one of the more corrupt countries even among transition states. Transition states cannot count on growing their way out of dishonesty).

Opening the economy is a policy choice that seems to reduce corruption. When a country opens its market to foreign investment, it is inviting participation in the economy by firms that may not be so willing to bribe public officials to gain access to markets and even to government contracts.

We do not see the stickiness for open markets between 1993 and 2000 that we do for inequality, wealth, and corruption (r^2 = .418, N = 16). Most transition countries had more permeable markets in 2000 than they did seven years earlier; five had exceptional records in this regard: Hungary, Poland, the Czech Republic, Romania, and Moldova. Once more, contemporaneous levels of market openness have stronger relationships with corruption than do changes in liberalization. The correlations between the TI index in 2005 and market liberalization in 2000 is .708 (N = 23) and is .577 with openness in 1993(N = 19). How free the markets were to foreign competition shortly after transition matters more than whether a country has become more open over time (r = .169, N = 19). Opening markets is a useful tool in fighting corruption, but its impact seems considerably smaller than other variables–and why it doesn't have a greater effect over time is unclear.

If inequality is a key factor in shaping corruption, what leads to increases in the unequal distribution of wealth in a society? I estimate a model for changes in equality from 1989 to 1999 (WIDER) in transition countries in Table 4-2--and it is clear that corruption matters. Three of the four factors shaping rises in economic inequality reflect either corruption or the failure of the legal system more generally (R^2 = .730, N = 18) More corrupt countries have greater increases in inequality.[14] The greatest effect comes from a growing shadow economy: As more and more people are forced into the informal sector, inequality rises. The level of disorder from street crime (from World Bank estimates, Hellman et al., 2003) also leads to growing inequality. Disorder from street crime penalizes the poor more than the wealthy (who can afford to hire protection). It dissuades businesses from investing in communities with high levels of lawless-ness, further limiting the economic development of poor neighborhoods.

Table 4-2 about here

There is a positive message in this estimation: Democratic countries had significantly smaller increases in inequality than those countries where political institutions are less free. This is heartening news, both for institutionalists and for citizens of transition countries where democratization has not progressed so rapidly. Democracy is *not* sticky: The correlation between the Freedom House index of democratization before transition (1988) and in 2003 is only .080 (N = 15). Even as recently as 1993, the correlation with the 2003 index was just moderate (r = .558). The level of democratization is related to the level of inequality, but *change in democratization* once more is not related to increases in inequality; the correlation is even slightly negative (r = -.129, N = 19). Many "partially free" countries in 1993 had become fully democratic by 2003, but there were six "not free" countries in 2003 compared to five seven years earlier. Democratization has the potential to reduce inequality, yet stronger institutions haven't emerged where they are most needed–in the least equal societies.

The Consequences of Inequality and Corruption

Inequality and corruption threaten transition not just because they threaten social solidarity. They also limit the capacity of the state to maintain order and to provide essential services–and they make some people wonder whether the transition is an empty promise.

The Failed States index is a measure of the capacity of a polity to maintain order and to deliver essential services (see Chapter 2), of the "vulnerability to collapse or conflict."[15] A key component of the index is the deterioration of public services, which is essential both for ordinary citizens and for businesses in a newly privatized economy. There is strong evidence that both corruption and inequality lead to weak states. High levels of corruption are powerfully related to both overall state failure (r^2 = .722, N = 27) and to the deterioration of public services (r^2 = .693, N = 27). Increasing inequality (more so than the present level of inequity) also shapes both state failure (r^2 = .429 N = 21 and poor service delivery (r^2 = .475, N = 21). (See Figures A4-19 and A4-20).

Inequality change seems less powerful than corruption in shaping state failure. Corruption directly leads to state failure and to inadequate public services. The state will have fewer resources to deliver services and people will lose faith in its honesty and fairness. They will try to avoid taxes and will have low expectations of being treated fairly. Compliance with the law becomes less compelling and the state will be less able to establish its authority. The effect of inequality on state failure is less straightforward. Rising inequality creates social strains and leads to less faith in the state as well as other citizens–ultimately with the potential to lead to create severe conflicts within the society. In a highly unequal society, service delivery is likely to be targeted more at those who can pay, either directly or through bribes. The poor may lack access to basic services and even when they do, they may not be able to afford the "gift payments" for hook-ups or for "customer service."

Democratization also matters for both state failure and public service deterioration (Table A4-1). Democracy makes a state better able to govern and to provide better public services. Yet honest government seems to matter at least as much. The most honest government will lead to a 1.80 change in the public service deterioration scale (from Slovenia's top-ranking 3.5 score among transition countries to Romania's level) compared to a change of 1.55 for democratic governments (to the level of Serbia at 5.0). Inequality matters a bit less, accounting for 1.2 units on the deterioration scale. Each factor makes a significant contribution to both state failure and poor public services, with the models accounting for ninety percent of the variance in each measure. Corruption, inequality, and a lack of democracy all contribute to poor public performance.

We see the same story with a different data base–the 2005 BEEPS. BEEPS asked its business respondents to indicate whether they have experience service interruptions in either low water supply, lack of phone service, or power outages. I estimate identical regression models for the three measures of service interruption in Table A4-2 and, overall, the three models are quite successful (with R^2 values ranging from .424 for lack of phone service to .684 for low water supply). The models include three predictors, change in inequality (WIDER), confident that the legal system will enforce contracts and property rights, and corruption. Changes in inequality and levels of corruption lead to poor service delivery in all three areas. Inequality increases are particularly powerful for low water supply. Even though power outages are more common than low water supply problems, they may be less problematic, since poor people may find ways to tap into the power grid even when they are not formally connected.

The impact of both increases in inequality and the level of corruption is sharpest where the poor are most severely affected. Lack of phone service is an issue only to people who can afford a phone–or who try to get a phone without success. Many people in transition countries, as in the West, have cellular (mobile) phones and pay by the call, so service delivery is not as critical an issue. They do not seek legal redress if their service is cut off, as they might with a low water supply or power outages, so an effective court system is less critical–and is not significant. The BEEPS data support the results from the Failed States index– changes in inequality and corruption lead to poor service delivery. There is no impact for democratization in these estimates.

The logical outcome of poor performance stemming from inequality and corruption is disappointment with the transition itself among many citizens. There is more than a little nostalgia for the "old regime," especially in countries that have not fared as well in transition. In the 1995 World Values Survey, the average rating of the current regime in transition countries on an ten point scale is 4.23, compared to 5.81 for the previous regime. People had positive views of the old regime in 10 of 18 countries, but in only two (Croatia and Azerbaijan) were the mean scores above 5 for the new system. In only 6 of 18 countries did people have a more positive view of the new system than the old, with the most upbeat scores occurring in Croatia and Poland and the most negative views in Russia, Moldova, Macedonia, and Ukraine.

DiTella and McCulloch (2003, 6) argue that people who are fed up with corruption and who wish "to return to the profits proposed by the social contract" will vote for left-wing parties in an attempt to redistribute some of the ill-gotten gains from corruption back to the poor. Corruption breeds envy and especially lower-income voters will demonstrate their unhappiness with inequality by supporting parties of the left. Inequality and corruption lead voters in transition states to become more likely to support Communist parties (Table 4-3). Increases in inequality are the strongest determinant of change in the vote for Communist parties across 20 transition countries. These findings are bolstered by the powerful aggregate relationships between the share of voters in transition countries identifying with left wing parties in the 1999 ISSP and the 2005 TI Corruption Perceptions index (r^2 = .858) and the 2000 WIDER Gini index (r^2 = .782). These results are based upon very small samples (N = 7), but they corroborate the findings in Table 4-3.

Table 4-3 about here

Voters punish more establishment parties by supporting the Communists and their promises to redistribute income back to those who have suffered during transition. Three measures of corruption from the BEEPS 2002 survey also play a key role in increasing support for the Communists: when gift payments constitute a significant share of business income, when the Mafia is (not) seen as an obstacle to business, and when businesspeople believe that the courts are not enforcing the laws.

All three measures reflect the view that the new regimes have failed to curb the abuses of the past. Gift payments by businesspeople will be reflected in “extra payments” that ordinary citizens must make for public services. Mafia power is a sign that the rule of law is weak, as is the unwillingness of courts to enforce the law. Each aspect of corruption puts burdens on businesspeople, but even more on ordinary citizens, who do not have as many resources to deal with the costs of corruption. (Clearly people who look to the Communists because they are upset with corruption have short memories.) Dishonest leaders will lead to resentment that some people are getting rich by illegitimate means–and to attempts to redress the situation through elections. In the next chapter I shall show that perceived increases in inequality and corruption in Romania leads people to demand that the state limit incomes of the rich.

Once more corruption and high levels of inequality push ordinary citizens to support the left. They lead businesspeople to be ever more cautious in dealing with each other. In the United States (and other Western societies) in the 1960s, before the decline of generalized trust and the rise of the litigious society, people in enterprises did “business on a handshake” (Macauley, 1963, 63). Your word was your bond and no legal protection was necessary, a sign of the high level of trust in society (Uslaner, 2002, 46). Back then, there were no enterprises in transition countries, but the lack of trust that characterized (post-)Communist publics was a great barrier to such informality in finance once markets came to transition countries. While the strong arm of the law may help obtain order when trust is lacking, an effective legal system ultimately depends upon a sense of social solidarity (Uslaner, 2002, 221).

In countries with low generalized trust and an weak and unfair legal system, relying upon the good intentions of others or the rule of law involves a leap of faith. Raiser, Russo, and Steves (2004, 58) argue that accepting credit from clients who may be strangers is an indicator of trust:. “A firm’s willingness to forego prepayment may be seen as an indication that its directors believe they will be paid fully and on time, either due to trust in the customer’s reliability or in the legal system’s ability to fairly adjudicate business disputes.” Across 26 transition countries, firms accepted about a third of their revenue from clients on credit, ranging from 6.5 percent in Uzbekistan and 10 percent in Tajikistan to 63 percent in Slovenia, according to the 2005 BEEPS.

What factors lead to such trust in business partners? I examine this question in two ways.

First, I present a cross-national aggregate analysis (Table A4-4) and then an analysis of individual responses from businesspeople in the survey using a two-level (hierarchical) model (Table 4-5). The aggregate model shows that the same factors that drive voters to support Communist parties–increases in inequality and corruption–make business people wary of giving credit to their clients. Increasing inequality and the perception of high levels of corruption lead to a smaller share of sales on credit.

Table 4-4 about here

When businesspeople see the system as corrupt, they are unlikely to believe that their fellow citizens will be honest either–and that they could not get justice if they had to go through the courts. The social strains that accompany increasing inequality make it less likely that businesspeople will adhere to norms of honesty and reciprocity. Businesspeople *are* more likely to offer sales on credit if they are members of the local Chamber of Commerce. Such membership may help sellers get to know potential clients–and thus reduce the uncertainty of dealing with strangers that is essential to generalized trust. Businesspeople may either meet their clients directly or gain information about their reliability from other Chamber members. Rather than rely upon a generalized faith in others or in the courts, transition businesspeople may fall back on the old Russian dictat, "Trust but verify" (popularized by American President Ronald Reagan).

I examine the survey responses to BEEPS 2005 in a hierarchical linear model. The individual-level models include perceptions of the legal system, corruption, bureaucratic regulations, social networks, and who the clients are. Surprisingly, neither the perception that the courts are fair or that the legal system will enforce contracts is significant, but they may be reflected in the willingness of people to take their cases to court if need be. While it may seem counterintuitive that businesspeople would grant credit to clients if they had to go to court frequently, willingness to use the legal system often indicates a high level of satisfaction with the legal system. The number of cases is also a measure of the total number of contracts a firm has. So businesspeople who have many clients will be more likely to go to court often–but also to accept a larger share of total revenue on credit.

Street crime leads business people to be wary about the security of their own business –and to be less likely to offer sales on credit. Street crime has one of the strongest effects in the model. Making gift payments to officials could lead to fewer sales on credit, but the opposite seems to be the case. Gift payments may ease the regulatory burden for businesspeople–and perhaps to establish a close connection with the police and judges–which might make reduce the risk in giving clients credit. However, gift payments to tax officials reduces the likelihood of extending credit: Perhaps people believe that if they have to bribe tax officials, they will have *fewer* rights protected in the legal system should creditors default. Customs inspectors are widely regarded as among the more corrupt officials, yet customs inspections has no impact on sales on credit.

Social and business networks are also critically important and both speak to how in-group and out-group ties shape business relationships. The more you rely upon friends and family as sources of information, the less likely you are to make sales on credit. When you rely upon very close associates, you will be wary of letting customers you may not know buy goods without prepayment. As in the aggregate model, membership in the Chamber of Commerce seems to provide the "right" amount of information about potential clients to permit more credit.

Multinational firms may be based in the West, where trust levels are higher and where demands for prepayment may indicate a lack of good faith.

Businesspeople dealing with foreign firms are exposing themselves to a more trusting environment. Businesspeople are wary of giving credit when they deal mostly with small firms. Small businesses may lack market capitalization–and, in a shaky business environment, may come and go, leaving creditors with large debts. Dealing with multinational firms–in essence, opening markets–forces businesspeople to sell on credit. Yet, few firms are in the international marketplace. Overall, less than four percent of sales across the 26 countries in BEEPS 2005 are with multinationals. Businesspeople are wary of giving credit when they deal mostly with small firms. Small businesses may lack market capitalization–and, in a shaky business environment, may come and go, leaving creditors with large debts. Dealing with multinational firms–in essence, opening markets–forces businesspeople to sell on credit. Most business (64 percent of sales) is with small firms, which still predominate in transition countries.

The country-level variables included in the model are corruption and generalized trust. Models with measures of inequality failed to converge. However, there is support for the argument that countries with more honest government and business have higher levels of sales of credit; and where trust is higher, there are fewer demands for prepayment.

Businesses give credit, then, when they deal with citizens and governments they believe to be honest, where they can either trust the courts or gain access to them through "gift payments," and when they are in strong positions to obtain information on their clients. Where such information is lacking–when people mostly rely upon friends and family to tell them about potential clients and when they deal with small firms that may not have well established reputations–they will be more likely to demand prepayment.

Businesspeople in transition states are not prone to give their clients the benefit of the doubt. Only a third are willing to make sales on credit. They will be reluctant to grant credit unless they have strong evidence that they will be repaid. This itself is not unusual, but in the West, firms worry less about what might happen if their clients default. There is less uncertainty about the fairness of the legal system–so giving credit is less risky. In the less secure and fair legal environment of transition countries, businesspeople verify first, then trust.

Corruption seems to be at the heart of problems at both ends of the economic spectrum: It leads some people--presumably those at the bottom of the income distribution–to vote for Communists. It leads others at the higher end of the income distribution–businesspeople–to withdraw from extending credit to clients. It affects people daily–when they hear about big corruption in the media or when they experience it in gift payments.

Demands for bribes are a constant annoyance to entrepreneurs and a mark of the corruption that inhibits the development of a market economy in transition (and other) societies. In BEEPS 2005, businesspeople were asked how common various "gift payments" are (on a 6 point scale) in a wide variety of contexts. Overall, most respondents did *not* report that extra fees were the norm– the highest scores came from "my line of business" (2.37 out of 6), getting business licenses (2.02), and obtaining government contracts (1.97), while the lowest score is for getting public services connected (1.47).

What shapes these extra payments? I estimate 10 identical aggregate regressions for different forms of gift payments in Table 4-5 across 20 countries. For each regression, I include three predictors: (1) the change in inequality (WIDER); (2) the belief of businesspeople (in

BEEPS 2005) that the court system is uncorrupt; and (3) how extensive the system of financial regulations in a country is (from the European Bank of Reconstruction and Development). A lower rate of increase in inequality and an uncorrupt legal system should lead to less frequent gift payments. So should extensive financial regulations. When businesses are forced to keep their books straight, they cannot have entries for "bribes." So when countries adopt regulations proposed by international banking firms, they are accepting the argument that businesses in transition countries follow the same rules as those in the West.

<u>Table 4-5 about here</u>

The three variables perform well in predicting the level of gift payments in eight of ten models, with R^2 values ranging from .426 (gifts to fire inspectors) to .702 (gifts for business licenses). The exceptions are for gifts to get government contracts and to safety inspectors (R^2 = .088 and .193, respectively). In the other eight equations, the change in inequality and the corruptibility of the court system are significant predictors of extra payments. The honesty of the court system also matters for gifts to safety inspectors. Financial regulations are only sporadically significant–in five of the 10 models (and one–for customs officials–at $p < .10$).

Changes in inequality matter most for those extra payments that are most common– in "my line of business," for business licenses, and to tax authorities. Inequality change matters for these three areas, especially to tax authorities (by the values of the unstandardized regression coefficients) where opportunities to "soak" the wealthy are greatest. Business licenses are the province of the wealthy, who also are most likely to offer bribes to tax collectors. These are also (together with customs officers) the same areas where the honesty of the court system and the extent of financial regulations matter most. Rising inequality, a corrupt court system, and weak financial regulations make it more likely that officials will demand bribes from those who can afford to pay. Smaller shifts in the income distribution, more honest courts, and stronger financial regulations protect (wealthy) businesspeople from predatory government officials. ***Lower rates of increase in inequality, a fair legal system, and strong regulations all work to make markets unfettered by demands for extra payments. Greater increases in inequality, corrupt courts, and weak regulations hurt the development of markets.***

Reprise

Inequality and corruption affect the day-to-day lives of people at both the bottom of the income distribution and at the top. Corruption robs the state of vital resources and makes less money available for public services. It also extracts a tax, in the form of extra payments, on people who can least afford to pay them (Kaufmann, Montoriol-Garriga, and Recanatini, 2005). It gives advantages to those who can pay, and, as I shall show in the next chapters, corruption becomes most salient when people make associate dishonesty with great wealth. Lack of access to essential public services will anger the poor, but the real "costs" of corruption come in areas where the wealthy can buy benefits that make them richer: in business and with tax collectors.

Just as the gap between the rich and the poor has grown in many societies–and especially in transition countries, the former Communist nations are becoming divided between those that seem to be on the path to becoming successful market democracies and those that are growing even farther away. There are now the makings of an inequality trap for the countries that are marked by high inequality and strong corruption. Some of the former Soviet republics have inequality levels at or above those of the least equitable developing countries. And their levels of corruption are also among the worst in the world.

The story is not quite so simple. While Georgia, Moldova, Tajikistan, and Azerbaijan (among other former Soviet republics) face daunting odds in combating corruption, the "successful" countries–even Slovenia, Estonia, and the Czech Republic–are not little Swedens or Finlands guiding the way to transparency and egalitarianism (much less high trust). Corruption is still very much an issue in these countries, as the pictures on this book's cover from Prague in May, 2006 show.

Growing inequality and persistent corruption makes the transition to market democracy difficult. Many transition countries–especially those caught in the inequality trapped–are also mired in weak institutions–with less than fully developed democratic institutions and especially with unfair legal systems. Inequality and corruption also are associated with a larger informal economy, less willingness of businesspeople to extend credit, deteriorating public service, and greater support of voters for Communist parties. The inequality trap takes a strong toll on the societies that have had the most troubled transitions. And it makes future "improvements" in either institutional structures or public policies more difficult. Dysfunctional governments are unlikely to "heal themselves" or to adopt policies such as open markets and universalistic social policies (see Chapter 5) that may be unpopular.

Even where there seems to be real progress toward a clean state, ordinary citizens don't always share this view. The Transparency International Corruption Perceptions Index shows that business elites in 2005 ranked Estonia as the 26th least corrupt country in the world (out of 160 nations). The Estonian business elite and government officials see their country as very honest as well, as the surveys I shall examine in Chapter 6 make clear. Yet, the Estonian citizenry *sees* *widespread corruption* and associates this malfeasance with growing inequality.

It is not surprising that Romanians see corruption everywhere and make a clear connection with inequality (Chapter 5), but it is less clear why Estonian citizens might make the same linkage. The answer seems to lie in the inequality trap: Economic disparities between the rich and poor continue to increase and people in transition countries, as elsewhere, make the link between an unfair distribution of wealth and dishonest behavior by people who have gotten rich. The story is just as much about how people think about corruption–and inequality–as it is about who actually has their hands in the till.

NOTES

1. The full text is available at: http://www.amateurgourmet.com/the_amateur_gourmet/2006/05/how_to_survive.html.

2. For the full set of nations ranked by Transparency International in 2005, former and present Communist countries averaged 3.42 on the Corruption Perception Index, compared to 7.97 for the West and 3.50 for developing (other) nations (N = 29, 21, and 110, respectively). On trust (imputed), the East bloc averaged .234, developing nations .220, and the West .388 (N = 25, 39, and 30, respectively). For the World Bank Gini index, the present and former Communist countries average .308, the West mean is .319, and developing nations average .443 (N = 23, 23, and 42, respectively).

3. See http://www.praguemonitor.com/ctk/print_friendly.php?id=33144, accessed May 30, 2006. I am indebted to Petr Mateju of the Czech Academy of Sciences for the citation.

4. On the 1-5 scale (with higher scores indicating better performance), the mean score for the imputed legal fairness index is 2.49 for the transition countries, 2.36 for developing nations, and 4.30 for the West (N = 24, 43, and 26, respectively).

5. These data come from the 2002 BEEPS (Business Environment and Enterprise Performance Survey) by the World Bank at http://info.worldbank.org/governance/beeps2002/ . The BEEPS 2005 data (see below) were graciously provided by Utku Teksoz of the European Bank for Reconstruction and Development.

6. Developing countries had an average score of 7.40, higher than any other group. The

sample sizes are 22 for the West, 42 for developing nations, and 23 for the East bloc.

7. There are 9,655 respondents in total, including 557 in Turkey, which I have excluded from these analyses since it is not a transition country.

8. The results are largely the same, whether one looks at the World Bank Ginis (available for only 8 Communist countries in 1980) or the Galbraith data (in 1987, available for nine countries, or in 1990, for 12 nations): The East bloc countries averaged, Gini indices of 26.7, 27.0, and 28.2, respectively, compared to the low-to-mid 30s for the West and the mid-40s for developing nations.

9. For details on the ISSP, see www.issp.org. The transition countries surveyed are: Bulgaria, the Czech Republic, East Germany, Hungary, Latvia, Poland, and Russia, Slovenia, and Slovakia. The Western countries are Austria, Australia, Canada, Cyprus, France, Israel, Japan, New Zealand, Northern Ireland, Norway, Portugal, Spain, Sweden, the United Kingdom, the United States, and West Germany. Also included are Chile and the Philippines. The percentages I report are the shares of respondents who answered "strongly agree" or "agree."

10. For the eight transition countries–there is no separate corruption measure for East Germany–the r^2 between the 2005 TI corruption measure and perceptions that you must be corrupt to reach the top is .588. For the full 25 countries, the r^2 = .385, but the Philippines is a strong outlier and without it, the r^2 rises to .595. For the WIDER 2000 Gini the r^2 values are .665 (for eight transition nations) and .035 (for 15 other countries) and for the WIDER change in Gini from 1989 to 2000, the r^2 values are .775 (for eight

transition nations) and .166 (for 10 other countries, with the wrong sign).

11. The regression coefficient is 1.092, indicating that the 2005 scores are virtually a one-to-one correspondence with those from 2004. A t-test that this coefficient is significantly different from 1 (which would indicate a perfect correspondence between the 2004 and 2005 scores) yields an F ratio of 2.06, with (1, 25) degrees of freedom and $p < .164$, so the coefficient is not significantly different from 1.

12. The Dutta/Mishra figures are not time series estimates and the Rosser, Rosser, Ahmed (2004) estimates have many fewer cases.

13. The Dutta/Mishra estimate of inequality for Belarus is 21.7 (transformed to a 0-100 scale), compared to the WIDER estimate of 29.4 for 1997 and 33.7 for 1999.

14. To get sufficient cases for analysis, I had to use the 2004 Transparency International Corruptions Perceptions Index here, but, as noted above, corruption is very stable over time.

15. http://www.fundforpeace.org/programs/fsi/fsifaq.php.