

IVAN SZELENYI – PETER MIHÁLYI

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# Inequalities: origins and consequences

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(Understanding the post-communist period, 1989 – 2025)

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**IVÁN SZELENYI** (b. 1938) is an American-Hungarian sociologist. He is William Graham Sumner Emeritus Professor of Sociology and Political Science at Yale University, Max Weber Professor of Social Sciences, and Foundation Dean of Social Sciences at NYU Abu Dhabi. He is a Fellow of the American Academy of Arts and Sciences. He holds honorary degrees from five universities.

In 1974, a transcript of a book he wrote in Hungary with fellow sociologist and author György Konrád, titled “The Intellectuals on the Road to Class Power,” was published outside of Hungary. The book contained critical thoughts about Communist-ruled societies. Before the book went into print, Szelenyi was arrested, expelled from Hungary, and stripped of his citizenship. After the political change in Hungary in 1989, his citizenship was reinstated. Since 1990, he has been an Ordinary Member of the Hungarian Academy of Sciences (HAS). In 2006, he received the highest state prize for scientific work, the Széchenyi Prize, and two years later, he was honored as an Honorary Citizen of Budapest. Beyond that, he was elected to the American Academy of Arts and Sciences in 2000. He is a Board Member of TÁRKI Zrt., the publisher of the present volume.

**PETER MIHÁLYI** (b. 1953) started his academic career after graduating from Karl Marx University of Economic Sciences in Budapest. Between 1983 and 1993, he was a researcher at the United Nations Economic Commission for Europe in Geneva (Switzerland). After returning to his native country, he became an active participant of the Hungarian privatization process. He served, *inter alia*, as Deputy Government Commissioner for Privatization in 1994/95 and played a major role in the largest transactions in the energy and banking sectors. In 1997/98 he was promoted to Deputy State Secretary in the Ministry of Finance. His portfolio included the pension reform, the preparation of the healthcare reform, and municipal financing. He is currently affiliated with the Corvinus University of Budapest as Professor Emeritus and the Central European University (Vienna) as a Recurrent Visiting Professor. He has authored 8 books and more than 100 academic papers. He has been a Corresponding Member of the Hungarian Academy of Sciences (HAS) since 2022. Between 2012 and 2024, he was Editor-in-Chief of *Acta Oeconomica*, an English-language quarterly of HAS.

## PREFACE by Ivan Szelenyi and Peter Mihályi

### *The origins of our thoughts*

This volume contains 12 English-language papers that we co-authored and published in print between 2015 and 2025. Many decades earlier, from 1972 to 1977, Peter Mihályi was one of Ivan Szelenyi's students at the Karl Marx University of Economics in Budapest. Then we did not see each other for a long time. Our regular and close collaboration resumed in early 2015, when it became clear at a Hungarian public presentation of Thomas Piketty's world-famous book<sup>1</sup> that our research programs were quite similar. Both of us were interested in inequality and economic growth. Over the past decade, in addition to two monographs<sup>2</sup>, we have jointly published more than 20 pieces in English and Hungarian. However, to prevent repetition and overlap among topics, some of our joint articles were left out of this English-language selection and from the Hungarian version as well.<sup>3</sup>

This book aspires to explain the dynamics of inequalities in post-communist countries after the fall of Communism. Communist governments were supposed to be egalitarian. This was never entirely true, but the standard of living was similar across the social ladder. Communist cadres and highly skilled professionals had somewhat higher wages and better access to scarce, desired goods, such as housing, than ordinary workers, but the differences were small. The interesting point is that *inequalities were generated by redistribution*. Ordinary citizens had to rely on existing legal and illegal markets to counter them. For instance, they had to build their houses with materials purchased on these markets, working without much state subsidy. This was the opposite of what redistribution is supposed to do in welfare capitalism, where, in principle, redistribution is supposed to narrow the gap between rich and poor.

With the transition to capitalism, after 1989, inequalities increased, and one could earn higher incomes and accumulate wealth on the market. But such an equalizing role of the market would work well only if markets were free. But the *de facto* distribution of capital goods, which were unequally distributed by inheritance, by oligopolies or monopolies already in the first place, was further reinforced by politics. During the transition from socialism to capitalism, political networks and the state played a more substantial role than in contemporary advanced capitalism. In a nutshell, the papers in this volume deal with these exceptional features of the transition countries.

Our point of departure is the analysis of profit and rent as the two competing sources of income. They exist in all complex societies. The question is which is the dominant source. There are, for instance, profit-seekers under feudalism, but feudalism primarily is a rent-seeking

1 Thomas Piketty: *Le Capital au XXIe siècle*, Editions du Seuil, 2014.

2 I. Sz. - P. M.: *Rent-seekers, Profits, Wages and Inequality. The top 20%*. Cham (Switzerland): Palgrave - Macmillan, 2019.; I. Sz. - P. M.: *Varieties of Post-communist Capitalism. A comparative analysis of Russia, Eastern Europe and China*. Leiden, Netherland: Brill, 2020.

3 *Az egyenlőtlenségek új formái* (The new forms of inequalities), Mimeo. In Hungarian. 2025.

system. Classical capitalism is profit-driven, which is complemented by rent-seeking. Socialism was a rent-seeker regime. Unsurprisingly, in transition, we can find more rent-seeking than under classical capitalism; in other words, politics and the state interfere more often in the functioning of market competition. After all, one of the first tasks was to create a bourgeoisie, among them a domestic grand bourgeoisie. But there was no capital wealth to be inherited, and to accumulate it through profit on free market competition takes too much time. But here it is, politics and the state help to give benefits like kings used to give to individuals loyal to political bosses and to the state. This is the story of instantly arising dollar-billionaires in Russia, China, Hungary, and virtually all transition countries. This is not corruption. The new rich do not steal; they receive what they have in exchange for their political and/or personal loyalty.

### *Worldwide inequalities in income and wealth*

There is no doubt that income and wealth disparities have increased in the developed world over the past 30-40 years. For at least 5-10 years now, we've been at a point where the fact of inequality has become *the* most important domestic political debate in many countries. Thus, wealth and income disparities have become the focus of social criticism, and within this, the assertion that competition is unfair is widely considered self-evident. It is believed that the powerful become increasingly wealthy through cheating, manipulation, and distorting the rules of competition in their favor, while the living standards of average people barely rise. Essentially, this was Donald Trump's main message in the American presidential campaigns ("not just the political system, but the entire economy is a big scam"). Many believe that when Britons voted for Brexit in the 2019 referendum, they were primarily protesting against their own elites. Similarly, a strong resentment on the left and the right side of the Hungarian public opinion drives the political life in the country according to such underlying gut feelings.

When economists and sociologists focus on measuring inequalities – as, for example, Piketty did – they tend to forget the obvious, self-evident fact that the most severe and unjust social divisions in today's society are actually the consequences of institutions that have survived from the *feudal past* and have little direct connection to *present-day capitalism* or free market competition in general. Although we lack reliable data on the distant past, many facts suggest that pre-capitalist societies were even more unequal than the modern world and certainly operated according to a very different logic. Inequality and oppression were almost exclusively based on classification by estate, race, ethnicity, or caste. Entry into various positions was possible only and exclusively by birth, whether it was for the privileged or the oppressed. In many parts of the world, such as the Middle East or Africa, emperors, kings, and tribal chiefs still occupy the top of the social hierarchy. They also own the country's most valuable capital assets: oil fields, diamond mines, shares in the largest industrial companies, land holdings, etc.

If we look at the hierarchy from the bottom up, it's impossible not to notice that the disadvantaged position of black people and indigenous people in the US, or aboriginal Australians, is based on ethnic discrimination. But the oppression of Muslims in India works the same

way, as does the fighting between Shia and Sunni Muslims in many parts of the world. Where Shiites are in the majority, they oppress Sunnis; where the latter are in the majority, the lives and property of Shiites are in danger. The income and wealth poverty of the Roma in Eastern Europe, including Hungary, also stems from historical roots. Gender discrimination has even more serious consequences, for example, in India or China, where millions of unwanted baby girls are killed before or shortly after birth. There are also other, less well-known forms of pre-capitalist distinction. For example, in Kazakhstan, the fact that every “citizen” of the country is registered as a descendant of one of three clans (*jüz*) ultimately determines who can attain a high social position and who must be content with insignificant wealth and power. Few people in Europe know that in many parts of the world, such as South Korea, the main rule today is that the family fortune is inherited 100% by the eldest son, while the others receive nothing.

In many countries, a significant portion of the poor are poor because they are first-generation immigrants. Here, too, we’re talking about big numbers. In the United States, 13.2% of the population is foreign-born, while the corresponding figure for the EU is 9.9%. Naturally, immigrants still find their place despite being at the bottom of the economic ladder in their host countries. The poorest people in rich countries – let’s say the bottom 10% – earn about three times as much as the top 10% in poor countries. By the way, it’s a matter of debate whether migration ultimately reduces or increases global inequality: the money sent home by guest workers abroad significantly boosts the incomes of those who remain, thereby reducing income disparities between countries.

All the above are relevant to understanding why we started our joint work with the criticism of Piketty’s book. We disagreed with Piketty’s main message that the inequalities in our globalized world are explained by the mechanisms of the capitalist market economy. We are convinced that’s not the case: ethnic, racial, and religious *discrimination* is the main cause of the dramatic poverty and seemingly insurmountable subjugation experienced worldwide.

### *Profits and rents*

But there is a second major issue that the present volume aims to address. Since the early 19th century, when the share of industrial and market economies organized around capitalist principles increased relative to land-based agriculture, the idea that “property is theft” (Proudhon) has been a common explanation among critics. In response to this simplistic, populist criticism, Karl Marx developed his own theory, which refuted it. He created a two-class national income model, where the poor laborers (L), coming from rural areas, compete for factory jobs, driving wages down to subsistence levels, while capitalists – competing among themselves – maximize profits by making their employees work more than 8 hours a day. According to Marx, profit originates from this surplus labor. However, capitalists cannot freely spend this profit because they must continually renew and expand their capital (K).

Marx’s works overshadowed and diminished the significance of David Ricardo’s groundbreaking discovery from two generations earlier, which stated that there are areas of the

economy, such as agriculture or mining, where owners – meaning landowners or mine owners – do not generate profit for themselves but draw rent without working because they have the opportunity to exploit their monopoly position. Since neither land nor mines are renewable, anyone who somehow acquired them will receive royalties (i.e., some kind of rent) for the rest of their life, and even for their children in perpetuity. Furthermore, there is a very significant additional difference between profit and rent. The size of profit usually depends heavily on the capitalist's skill and cleverness, while rent is independent of this: a foolish landowner receives the same amount of rent as a smart and talented one.

Researchers looking for the causes of today's inequalities discovered the potential in developing Ricardian theory 15 years ago. American Nobel laureate Joseph Stiglitz, Danish-born but American-based sociologist Aage Sørensen (1941-2001) – and of course many other authors as well – have provided numerous important examples demonstrating that rents, independent of individual performance, play an increasingly significant role in the formation of income and wealth inequalities. First, this is how the real estate market works. From London to Moscow, from Shanghai to Singapore, vast fortunes have accumulated in the hands of families who inherited apartments, houses, or land in the heart of these cities from their ancestors. By the way, in these metropolises, real estate prices are not driven up solely by domestic demand; billionaires and millionaires from other countries also want to buy apartments in these cities.

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The writings in the present volume are not arranged chronologically; instead, they were grouped into three chapters. The first chapter goes back to the fundamental topics of classical political economy (the measurability of value, the production and distribution of national income, etc.). Four papers were selected for the second chapter, all of which argue that the post-communist system in Hungary between 2010 and 2025 shared many similarities with what was happening in the outside world, namely, the proliferation of authoritarian regimes at the detriment of liberal, democratic political institutions. The five papers in the third chapter examine in detail the applicability of our interpretation of rents. The most important conclusion of our investigations is the assertion that the concept of rent and rent-seeking behavior is more suitable to grasp the essential features of the post-communist systems than the widely used label of corruption.

The Authors  
November, 2025

# THE THEORY OF RENT

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## 1. Wealth and capital: a critique of Piketty's conceptualization of return on capital

### *Introduction<sup>1</sup>*

While the question of inequality was a central theme in 19th-century economics, in the 20<sup>th</sup> century, the issues of inequality of distribution of incomes and wealth tended to be neglected. When it was brought back to the centre of attention, for instance, by Kuznets (1955), it was assumed that economic growth would automatically take care of the issue. Over the past few years, the topic has received increasing attention, especially with the path-breaking works of Joseph Stiglitz, *The Price of Inequality* (first published in 2012) and Thomas Piketty's *Capital in the Twenty-First Century* (first published in French in August 2013). Anthony Atkinson is one of the rare economists who studied income distribution, inequality and poverty over the past several decades, recently adding another impressive volume, "*Inequality. What can be Done?*" (2015) to his many publications on the topic.

Based on an extraordinary international data collection effort<sup>2</sup>, Piketty believably claims that the reduction of inequalities in the advanced capitalist countries during the six decades between 1910 and 1970 was an exception. Since then, capitalism has been gradually returning to higher levels of inequality as seen in earlier times<sup>3</sup>, and is now even more likely to become further unequal unless an appropriate policy response is found during the remainder of the 21<sup>st</sup> century.<sup>4</sup> According to Piketty, inequalities are not only increasing, but capitalism is becoming unequal in a different way: accumulated capital is inherited within capitalist families. Much like the Bible says: "*For whoever has will be given more, and they will have an abundance. Whoever does not have, even what they have will be taken from them.*"<sup>5</sup>

Piketty's main findings and predictions were enthusiastically received by an influential part of the economic profession, the media, the wider public, and many international organisations as the right answer to the dilemmas generated by the international financial crisis of

1 The first version of this paper was submitted to the *American Economic Review* (AER) in the Autumn of 2015 under the title „Profits or Rents: The Origins of Inequality (A post-communist perspective)”, but it was rejected. The next draft was submitted to the *Cambridge Journal of Economics* (CJE) on 14 November 2015. An electronic version was published by CJE in December 2016. Printed version was published in *CJE* in 2017 (Vol. 41. Issue 4 (July) pp. 1237-1247). CJE is published by the Oxford University Press.

2 The World Top Income Database, see <http://topincomes.parisschoolofeconomics.eu/>

3 See in particular Figures 10.1 – 10.6 on wealth inequalities calculated for adults only in Piketty (2014) pp. 344-349.

4 It is another, though not unimportant, matter that the period between 1910-1970 was burdened with – *inter alia* – the Great Depression, two world wars, and the Iron Curtain.

5 Matthew 25:29. New International Version.

2007-2008. Concurrently, in a flagship publication, the OECD (2015) took an unambiguous position. They claim that income inequality had a sizeable and statistically significant negative impact on the long-term growth in 19 core OECD countries between 1990 and 2010. The World Bank (2013) is focusing on the future. Their ongoing *Shared Prosperity Program* aims at condensing of extreme poverty<sup>1</sup> from the present 20% to below 3% by 2030 at the world level through policies targeting the bottom 40% of the income scale in every country of the world.

Piketty's book was translated into English, German, Spanish, i.e., the languages of the advanced Western economies, but also into the national languages of 16 post-socialist countries, including Russian and Chinese.<sup>2</sup> This can be assessed as a clear sign that inequality is a burning issue in that part of the world, too. Within these countries, the rise of inequalities after the 1989/1990 regime change and the lock-stock-and-barrel takeover of the capitalist system was even more spectacular than in the Western world. Sizeable assets were accumulated in the hands of a few self-made billionaires. On the 2015 *Forbes* list of the world's top 100 billionaires, the names of four Chinese and six Russian businessmen could be found.<sup>3</sup> Before 1989, there were no billionaires in the communist countries. Names from these two countries appeared on the list in 1997.

Piketty is essentially right, but for the wrong reasons.<sup>4</sup> We agree with him that inequalities are growing and share his view that this is a major threat to the legitimacy of the liberal order at both the national and international levels. At the same time, we are deeply sceptical about his central explanation, namely that excessive growth of profits is the main reason for inequalities, which in turn slows growth and generates popular dissatisfaction in the long run. Logically speaking, the rising income and wealth inequalities convincingly documented in Piketty's book<sup>5</sup> *may* come from the  $r > g$  model, but our paper will demonstrate that Piketty's line of argumentation is based on a statistical artifact.

The rest of the paper is structured as follows. The first section confronts Marx and Piketty. While Marx, in his theory of exploitation, was concerned about the increasing inequalities between profits and wages, he did not believe that such inequality might bring capitalism down. Marx needed the since-falsified theory of declining rate of profit to predict the fall of capitalism. Piketty assumes that inequalities present an imminent challenge to capitalist reproduction, regardless of whether they originate from capital or wealth. In the second section of the paper, we address the difference between these two categories. We present a double argument: while wealth is directly measurable, capital is a statistical artifact. Furthermore, while profit as income from capital is consistent with an equilibrium model and poses no direct threat to capitalism, rents from wealth can undermine the meritocratic legitimacy of competitive markets and turn the system into patrimonial capitalism.<sup>6</sup>

1 The proportion of people living on less than 1.25 international dollars, calculated at 2005 purchasing power parity.

2 <http://piketty.pse.ens.fr/fr/articles-de-presse/86> (Accessed: 6 August 2016).

3 <http://www.forbes.com/billionaires/list/3/#version:static> (Accessed: 6 June, 2015).

4 Our overall assessment of the main findings of Piketty is very similar to Rowthorn (2014), but we use the present paper to focus on different issues.

5 *op. cit.* Tables 7.1. – 7.3.

6 For a detailed analysis of the problems of rent-seeking in the post-socialist setting, see Mihályi – Szelenyi (2016).

### *The source of inequalities – exploitation or something else?*

In the descriptive analysis of the capitalist system of our times, Piketty works with a *3-5 class statistical model*: the top 10% of wealth-owners constitute the upper class, the next 40% is the middle class, and the bottom 50% is the lower class. Within the upper class, he then distinguishes the top 1% and the top 0.1%. In the explanatory model, by contrast, Piketty uses the Marxian *two-class political economy model* (capitalists and workers) and takes no full account of the special situation of the self-employed who generate their income from their own work and the assets they own. This is not a small omission and certainly affects the income distribution data. In 2013, the share of self-employed in the working population was 16.5% in the EU27 and 6.6% in the US.<sup>1</sup> The possible complications arising from this are given by Guerriero (2012). The income redistribution function of the modern capitalist state is almost entirely left out of Piketty's basic model.

In Volume I of *Capital*, Karl Marx already discussed profit-wage differentials as a central issue of the rising, industrialized system of production. He interpreted this process in an equilibrium model, although not with modern technical terms. In an attempt to elucidate exploitation, Marx proposed a structure with owners of the capital stock (K), as an ever-shrinking minority and with a growing number of wage labourers who only receive the historically defined costs of reproduction of their labour power. Nevertheless, this is a positive-sum game: profits have to be reinvested into the production process, hence creating new jobs and/or increasing wages. Piketty accepts Marx's theory, according to which there is a tendency for an infinite accumulation of capital, so K is concentrated in fewer and fewer hands.

In the Marxian model, the infinite trend toward capital accumulation is explained by competition amongst capitalists and through the theory of exploitation. These mechanisms are of importance, and Piketty is well aware of their significance, noting that the entire Marxian theory is based on the *labour theory of value*, disputed by a high majority of economists over the past hundred years.

But despite his questionable point of departure, Marx arrives at some insightful conclusions. Marx wanted to show that property is not “theft” (Proudhon, 1840). He insisted that in all market exchanges, equivalents are exchanged. It is not the personal greed of the capitalists that drives the process of exploitation and the extended capitalist reproduction process. The capitalists pay the full price of the labour power of the workers (hence the historically defined costs of reproduction of labour power) to those whom they employ, but they keep workers working beyond the hours necessary to cover these costs, and they appropriate the surplus created during the extra hours of work. In a perfect competition among capitalists, the individual capitalist has no choice. He has to keep wages at the level of reproduction of labour power, and he needs the surplus value (profit) to reinvest in order to remain competitive with other capitalists. Hence, Marxists insist that the wage-profit margin will increase over time at the detriment of workers, although all in all, the relatively low wages of the working class and the relatively high profits of the capitalist class fit into an equilibrium model.

1 <https://data.oecd.org/emp/self-employment-rate.htm>, accessed on 9 July 2015.

Under these circumstances, as we have just shown above, capitalist expanded reproduction is a positive-sum game. If profits have to be reinvested, more profit may mean more jobs and, what Marx himself did not consider, higher wages for workers (to generate sufficient demand for capitalist production). John Roemer (1982), arguably the most distinguished “rational choice neo-Marxist” correctly noted: “*The neo-classical model of the competitive economy is not a bad place for Marxists to start their study of idealised capitalism*”.<sup>1</sup> While Piketty expressively rejects the Marxian theory of exploitation, he tends to concur with Marxists, assuming that apart from exceptional periods when governments intervene in the economy with redistributive policies or when wars destroy the accumulated private wealth, wages remain low while incomes on capital keep increasing.

But why does the infinite tendency towards capital accumulation and increasing inequality matter, if the capitalists keep reinvesting the profit in the production process hence creating more jobs and/or higher incomes? Marx offered a revolutionary answer, which proved to be wrong as well, namely the theory of the declining rate of profit.<sup>2</sup> But if that is the case, the capitalist class has to increase the rate of exploitation  $s:v$ , that could only lead to the absolute impoverishment of the proletariat, which eventually has to culminate in a social revolution and abolishment of capitalism.<sup>3</sup> As a prisoner of the labour theory of value, Marx could not consider the possibility that investment into constant capital can increase (occasionally tremendously) the national income (or GDP) of a country. In his closed model, which includes the reproduction of labour as well, a productivity increase cannot yield an increase in value or surplus value.

“*An increase in the quantity of use values is an increase of material wealth. With two coats two men can be clothed, with one coat only one man. (...) However then productive power may vary, the same labour, exercised during equal periods of time, always yields equal amounts of value*.”<sup>4</sup>

But once we step out from the labour theory of value, we cannot question that cheap technology, for example, computers, can have massive productivity gains and hence lead to a rise in national income. This explains why profits in the real world did not decline, the rate of exploitation did not grow, the revolution did not happen, and instead the real incomes of workers have increased enormously since Marx’s time.

Piketty replaces the theory of exploitation with his own innovation, the  $r>g$  formula. In this model, the absolute size of the gap between  $r$  and  $g$  explains the statistically observable magnitude of and variations in wealth inequality, where  $r$  is the net annual average rate of return on capital (K) and  $g$  is the economy’s annual average growth rate. The relationship between  $g$  and  $r$  is not fixed in time or in space; theoretically, all possibilities are permitted ( $r = g$ ,  $r > g$ ,  $r < g$ ). But historically, based on his own estimations covering the period from Antiquity until 2012, Piketty claims that in the world as a whole, and more certainly in Britain

1 Roemer (1982), p. 196.

2 This was elaborated in *Capital*, Vol. III, Part III, hence in a volume Marx never authorized.

3 See *Capital*, Vol. III, p. 250.

4 As we can read this on the very first pages of Volume I of *The Capital* (Ch. 1. Section 2.: The twofold character of the labor embodied in commodities.)

and France,  $r$  was significantly larger than  $g$  (4-5 per cent vs. 1-2 per cent) most of the time, except for the last hundred years.<sup>1</sup>

Furthermore, he assumes that the wage and salary earners do not have (net) savings ( $s_w = 0$ ), meaning they cannot accumulate wealth.<sup>2</sup> By contrast, the upper classes (especially the top of the upper class, the top 1% or 0.1% of the families) are modelled with exceptionally high savings rates ( $s_p \approx 1$ ) and cost-effective investment strategies thanks to diminishing relative wealth-management costs. Thus, these elites appropriate a higher proportion of national income, and – *a fortiori* – of national wealth at the expense of everyone else. Under these circumstances, if  $r > g$  holds, this immediately leads to growing inequalities.

### *Measuring capital and wealth*

Capital, together with *profit* and *rent*, are rather heuristic classifications. In fact, it is very difficult to find correct statistical measures for any of these concepts. Even if such headings are listed among the measured economic variables, they often reflect merely the country's prevailing taxation framework, rather than the underlying political economy reality. For example, in both advanced and less advanced market economies, there are strong tax incentives to declare labour income as capital income. In many places, the main motive to buy real estate for housing purposes rather than renting a place to live is explained by the deductibility of interest expenditures from personal income tax. The incentives of the self-employed, already mentioned above, are largely a matter of taxation rules as well. Hence, when the rich are paying low taxes, it is hard to know whether the system of taxation is not sufficiently progressive, or the crux of the problem is tax avoidance and tax evasion. It is not by chance that the World Bank decided to measure inequality by consumption rather than income.

Measuring the stock of *private capital* ( $K$ ) is fraught with even more profound theoretical contradictions. As it is well known to the readers of this journal, the fundamental critique of the neoclassical capital theory goes back to the writings of P. Sraffa, J. Robinson and N. Kaldor in the 1950s and early 1960s. This debate is known in textbooks of the history of economic thought as “Cambridge Capital Controversy” – an allusion to the affiliation of the main protagonists of the debate in Cambridge (USA) and Cambridge (UK).<sup>3</sup> Total national wealth as a macroeconomic variable is relatively easily captured both conceptually and in statistical practice. In contrast, *private wealth* ( $W$ ); which is in the focus of Piketty's theory<sup>4</sup>, features only in tax records which are incomplete and unreliable for the very rich, especially

1 In the light of many criticism of the “ $r > g$ ” model, including Acemoglu – Robinson (2014), Piketty (2015a) has later weakened his main causal explanation of wealth inequalities: “It may well be necessary to introduce time lags over much longer time periods: the process of wealth accumulation and transmission typically spans over generations, so it would be perhaps be better to use the average  $r - g$  observed during 30 or 50 years.” (*op. cit.* p. 43.)

2 In our times, one country where this assumption is certainly not valid is China, where – for a number of reasons - working families are known to save a large share of their incomes.

3 For more recent broader discussion of the consequences see e.g. Keen (2011), Felipe-McCombie (2013) and Moseley (2014).

4 In his interpretation, public wealth in the developed countries is insignificant, or even negative due to the accumulated public debt. Piketty (2014) p. 48.

in post-socialist countries. It is not by chance that there is not a single post-communist country in the World Top Income Database with sufficiently long time-coverage. Surveys are no solution either, as in medium and small countries, there are few observations of the top 1% or the top 0.1% of the population.

Privately owned capital is composed of assets directly involved in economic production aimed at profit maximization.  $K$  needs to produce profits in the long run as otherwise, banks will not provide funding and eventually the firm will be beaten by competition. In contrast, many forms of private wealth are not meant to generate financial return. Real estate, works of art, pension entitlements, life and health insurance policies, or cash holdings are trivial examples.  $W$  can operate as or be converted into  $K$ , but the inverse transformation is also important when intergenerational transfer occurs through inheritance. When marriages are broken, the divorce often implies conversions from  $K$  to  $W$ , as well.

As Stiglitz (2015) demonstrates in his latest book-sized paper, much of  $W$  is generated not from profits, but from *private rents* arising from deviations from the standard competitive paradigm.<sup>1</sup> His example states that firms can generate rents for their owners by creating and exploiting information asymmetries.<sup>2</sup> But, more importantly in our view, changes in wealth – both upwards and downwards – are associated to a very large extent with relative asset price fluctuations. E.g., the values of works of art, as well as the value of stocks and foreign currency holdings, also oscillate in broad ranges around the average rate of inflation. In some urban areas around the world, from New York and San Francisco to Moscow, Shanghai and Singapore, tremendous wealth has been generated merely from the scarcity of highly desirable locations. To make the matter even more complicated, the demand for housing no longer comes from just people who live in these cities all the time, but from the global wealthy who want to have houses in the above-mentioned globally attractive cities.<sup>3</sup> This private, consumption-oriented wealth becomes the property of a new urban “aristocracy”, which passes this wealth down from generation to generation. Such wealth, reminiscent of the wealth of land ownership of privileged estates under feudalism, is concentrated in the hands of the top 1% or even 0.1% of the social hierarchy. But there is a relatively large upper-middle class, say the top 20% of the countries concerned, which also benefits from the price inflation of their inherited housing wealth. To this extent, we are facing more *generational conflict* rather than a rivalry between employees and owners of private businesses. In the UK, dwellings comprise two-thirds of the capital stock in private ownership, which is to a significant extent the unintended consequence of ill-designed taxes levied differently on capital asset gains in general and on own owner-occupied housing assets.

In an attempt to measure  $K$ , Piketty disregards further specificities of the 21st-century advanced capitalism. The total value of physical assets owned by flesh and blood capitalists and used primarily for generating profits is relatively small. According to the NBER, privately owned non-residential assets (equipment and structures) amount to merely 32% of the total

1 *op. cit.* Part I. p. 8.

2 *op. cit.* Part I. p. 26.

3 We are grateful to Daniel Treisman for this observation.

accumulated fixed assets of the US economy.<sup>1</sup> A considerable part of the country's capital is publicly owned (transport infrastructure, health, educational and cultural facilities, military assets, etc.). It goes without saying that the accumulation of these assets in the hands of the state from the taxes paid by households and businesses is not doing any harm to ordinary workers or employees. This type of capital accumulation is good for social equity. In many dimensions, the use of these assets by ordinary citizens is free of charge and hence constitutes a very important component of their living standards. In 2013, according to the estimates of the US National Bureau of Economic Research (NBER), the share of public ownership within the net stock of fixed assets (including consumer durables) was 25%. Beyond this, America's federal government owns 25% of the country's land.<sup>2</sup> Therefore, disregarding state assets as a part of a nation's capital, as Piketty does, is totally misleading.<sup>3</sup>

### *Piketty's "r" is a statistical artifact*

In his two-class political economy model, Piketty defines net return on capital ( $r_{\text{net}}$ ) as inflation-adjusted, after-tax, realised

- *profits*, generated by businesses, including the self-employed, but excluding the entire non-profit sector;
  - + dividends, capital gains<sup>4</sup>, the effect of changes in the exchange rates;
  - + rents and other income from capital, which include
    - ▶ the interest income of all financial assets (e.g. pensions),
    - ▶ earned or imputed rental incomes from real estates,
    - ▶ license fees, royalties, etc.
  - capital losses arising from major wars or nationalisation, and
  - ▶ the total costs of managing private wealth<sup>5</sup>.

In advanced economies, the long-run average numerical value of  $g$  is about 1.5-2.0 % annually, reflecting the average growth in productivity throughout the *entire* economy, including the public sector.<sup>6</sup> By trying to compare two small magnitudes,  $r_{\text{net}}$  and  $g$ , the percentage rate of return on capital and the percentage rate of growth of real national income, respectively, Piketty unknowingly falls into a statistical trap. Reading the book, it is easy to miss the fact that Piketty has no direct measure of  $r$  but instead relies on macroeconomic equations (identities).

1 Bureau of Economic Analysis, last revised on September 17, 2014. The value of land is not included in the NBER wealth account data cited here.

2 *The Economist*, 13 June, 2015.

3 *op. cit.* pp. 123-131.

4 On this item, see Rowthorn (2014).

5 I.e. - the monetary value of the work the capitalists have to carry out themselves or that which they pay others to do for them.

6 If there is population growth, the value of  $g$  is correspondingly higher.

For the last hundred years, time series of  $g$  have been reasonably accurate and methodologically harmonised among the countries. The time series for  $g$  reproduced in Table 1 were directly calculated by Piketty using the widely accepted Maddison (2010) GDP database, which is an independent source and therefore does not need to be challenged here.<sup>1</sup> In contrast, Piketty's definition of return on capital  $r_{\text{gross}}$  or  $r_{\text{net}}$  doesn't even remotely correspond to any systematically collected statistical data.

Table 1: Piketty's underlying estimates and no-change policy conjecture on gross and net return to capital ( $r$ ) and the growth rate of the world economy ( $g$ )

Years	(1)	(2)*	(3)	(4)
	$r_{\text{gross}}$	$r_{\text{net}}$	$g$	$r_{\text{net}} > g$
worldwide annual period averages in %				
0-1000		4.5	0.0	yes
1000-1500		4.5	0.1	yes
1500-1700		4.5	0.2	yes
1700-1820		5.1	0.5	yes
1820-1913		5.0	1.5	yes
1913-1950	5.1	1.1	1.8	no
1950-2012	5.3	3.2	3.8	no
2012-2050	4.3	3.9	3.3	yes
2050-2100		4.3	1.5	yes
2100-2200		4.3	1.5	yes

*Note:* \* Minimum historical estimates for "pure" return. See Piketty's own footnote no. 28. in Chapter 10 (p. 614).

*Source:* Figures 10.9 - 10.11 in Piketty (2014) and Technical Appendix Table S10.3 available online only at <http://piketty.pse.ens.fr/files/capital21c/en/pdf/supp/TS10.3.pdf>, accessed 21 July 2015. Piketty's  $r_{\text{gross}}$  and  $r_{\text{net}}$  estimates for Britain and France see Figures 6.3 and 6.4 in the book.

<sup>1</sup> Except for the fact that some of the methodological differences between GDP (in Maddison) and national income (used by Piketty) were disregarded (e.g. depreciation).

For readers of the book, it is not easy to notice that Piketty doesn't even try to build a time series of  $r_{\text{gross}}$  or  $r_{\text{net}}$  from regular statistical sources. His estimation procedure for the past (before 2012) works backwards: he computed  $r_{\text{net}}$  from an accounting identity that he himself defined at the beginning of the book and then consistently referred to as the *First Fundamental Law of Capitalism*:

$$(1) \quad \alpha = r \times \beta,$$

from which he obtained

$$(1a) \quad r_{\text{net}} = \alpha/\beta,$$

where  $\alpha$  is the share of income from capital within national income ( $Y$ ) and  $\beta$  is the capital/income ratio

$$\beta = K_{\text{net}}/Y,$$

in which  $K_{\text{net}}$  is the net value of privately owned capital (assets *minus* liabilities). For example, if  $\beta = 600\%$  and  $\alpha = 30\%$ , then  $r_{\text{net}} = 5\%$ .<sup>1</sup>

While independent statistical raw data for  $Y$  and  $\alpha$  are available in the national accounts for many countries (though not for all and not for two thousand years), data on the net value of private capital ( $K_{\text{net}}$ ) has never been collected systematically. Thus, there are two free variables in the model:  $r_{\text{net}}$  and  $K_{\text{net}}$ .

At the first instance, Piketty's *Second Fundamental Law of Capitalism*

$$(2) \quad \beta = s/g,$$

where  $s$  is the national saving rate, appears to be helpful to compute  $r_{\text{net}}$  mechanically by solving equation (1a). In some places Piketty refers to this equation as the Harrod-Domar-Solow formula. Using Piketty's own illustration again, if  $s = 12\%$ ,  $g = 2\%$ , then  $\beta = s/g = 600\%$ .

The *Second Fundamental Law*, however, does not help, for at least three reasons. Firstly, the smallest problem is that the inclusion of the Second Law increases the number of directly unavailable statistical variables. But let's assume that  $s$  can be reasonably estimated somehow, without getting into circular argumentation. More importantly, as Piketty himself declares, equation (2) is not meant to be an accounting identity, but an asymptotic law, meaning that it is valid only as a tendency, and not suitable to compute  $\beta$  for each calendar year. However, the essential obstacle to integrate equation (2) in the arithmetic exercise of calculating  $r_{\text{net}}$  is, that if  $g = 0$ , then the equation contains a singularity, a divide by zero, which sends  $\beta$ , the capital/income ratio to infinity, which in turn would send  $\alpha$ , the share of national income accruing to the owners of private capital also into infinity according to equation (1). This is a serious confusion in the model:  $\alpha$  cannot be larger than 100%<sup>2</sup> Thus, equation (2) cannot be used in the computation of  $r_{\text{net}}$ , but even if it is not used, it undermines the general validity of the First Law for those years when  $g$  was equal to or close to zero. On the other hand, as

1 See Piketty (2014) p. 52 and pp. 201-203.

2 This was also noted by Cooper (2014).

the data taken from Maddison (2010) in Table 1 demonstrates, the rate of economic growth ( $g$ ) was indeed zero or very close to zero historically for 1500 years.

Facing all the difficulties to come out with a straightforward computation method for  $r$ , the key variable of his theory, Piketty cites anecdotal examples throughout the book on minimum and average *pre-tax* capital returns in different asset classes, such as farm land or pension annuities, for different countries and epochs to show that his computation results for  $r_{\text{net}}$  fit into the historical picture.<sup>1</sup> Then, in the very last logical step, he contends that the 4-5 % range he arrived at must have been the right number for  $r_{\text{gross}}$  in all other asset classes as well. Otherwise, people would have chosen other forms of long-term investments rather than land-ownership or investments in pension annuities.

This last step of the argumentation makes sense only if one accepts the postulate of efficient capital markets for the entire history, including the pre-capitalist centuries.<sup>2</sup> However, *a priori* arguments and many historical examples suggest the contrary, claiming that the existence of large variation of the return on capital both in time and space arises from – *inter alia* – the different riskiness of investments at the individual transaction level. E.g., it is well-known that until the 16<sup>th</sup> century short-term interest rates of 10-25 per cent p.a. were not unusual throughout Western Europe.

While it is true that in the past, as well as today, there are lots of businesses with annual real returns of 10 to 25 per cent, or even larger, behind every brilliant business transaction, there are  $n$  times more failures, with *huge losses* and no profits at all. But what is the true value of  $n$ ? We cannot know. In other words, there is no reason to believe that the values of  $r_{\text{net}}$  calculated from equation (1) are correctly reflecting the historical averages of successes and failures in the same way as added value (GDP) or national income data aggregate the net result of all the growth-positive and all the loss-making, growth-negative economic transactions. On the contrary, it is much more reasonable to accept that the true  $r_{\text{net}}$  figures are much higher than 3-4 per cent (as in Table 1). In the case of US-based non-financial companies, for example, it has been recently estimated that their inflation-adjusted global return on capital was never below 7% during the last half-century. Moreover, the  $r_{\text{net}}$  values for this sample have been displaying a growing trend, reaching in some years 16% by the end of the analysed 1963-2013 period.<sup>3</sup> The post-tax rate of company profits in the UK, measured net of depreciation, is around 10-12% with no obvious secular trend over recent decades, once again much higher than “calculated” by the French author.<sup>4</sup>

It is worth mentioning that the sudden increases in the difference between  $r_{\text{gross}}$  and  $r_{\text{net}}$  values in the periods 1913-1950 and 1950-2012 (as shown in Table 1) also remain statistically unproven in Piketty's book, despite their importance in the historical accounts of the author. Strangely enough, Piketty's conjecture for the likely development of  $r_{\text{net}}$  values for the future

1 See e.g. *op. cit.* pp. 52-55, p. 163, pp. 201, 206-210, 353-355, 358-359, 447-449, and 456-457.

2 Indeed, in Piketty (2014) Figures 10.10 and 10.11, the 4.5-5.1 per cent value of  $r$  is shown to be roughly constant from Year 1, A. D. until 1913.

3 Excluding goodwill. See McKinsey (2015).

4 The authors are grateful for this information to one of the anonymous referees of this paper.

is a direct extrapolation and not backward calculations based on equation (1a). He simply assumes that the value computed for the period 1990-2010 (about 4%) will continue in the remaining decades of the 21<sup>st</sup> century.<sup>1</sup>

## Conclusions

Wealth and capital are different concepts. The distribution of wealth is reasonably well measured, while capital is not. Statistically measured changes in the distribution of private wealth cannot be explained by the fluctuations of profits earned by the owners of large capitalist businesses, as Piketty contends. We therefore agree with Atkinson and Stiglitz: Piketty would have been better served if he had called the book "Wealth in the 21<sup>st</sup> century". Furthermore, while profits arising from business capital under the conditions of perfect markets tend to contribute to increasing the profit/wages gap, it only maintains the "satanic mills" of capitalist reproduction, rather than posing a new challenge to capitalism. The more recent observable rise in social inequalities is largely attributable to the large share of private housing wealth in countries' total capital stock, but this has little to do with the so-called "fundamental laws" of the capitalist mode of production. On the other hand, increasing differences in wealth and in incomes generated from different types of rents undoubtedly challenge the meritocratic self-legitimation of capitalism. The rents accumulating in the hands of families of the top 20% of society can lead to "re-feudalisation", a possibility Adam Smith was already concerned about in the late 18<sup>th</sup> century. This is much more significant than the pole position of the top 1 or 0.1%.

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<sup>1</sup> *op. cit.* p. 354.

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## 2. Profits and rents in advanced market economies

### I. Introduction

The purpose of this paper<sup>1</sup> – the third within a series of our similar writings<sup>2</sup> - is to “bring rents back in”, by and large neglected by mainstream economics. In a way, we turn from Smith and Marx to Ricardo in search of a theoretically sound explanation of the phenomenon of “abnormal” or “extra” profits – as they are often labelled in current scholarly discussion.<sup>3</sup> While the question of inequality was a central theme in 19th-century economics, in the 20<sup>th</sup> century, the issues of inequality in incomes and wealth tended to be neglected. When it was brought back to the centre of attention, for instance, by Simon Kuznets (1955), it was assumed that economic growth would automatically take care of it. During the past few years, the topic received increasing attention, especially after the unconventionally voluminous, but nevertheless hugely successful book of Thomas Piketty, *Capital in the Twenty-First Century* (first published in French in August 2013).

According to Piketty, inequalities have not only increased since the 1970s, but capitalism has become unequal in a different way: more and more wealth is inherited. Western-type capitalism has become patrimonial capitalism. In a sense, capitalism is being re-feudalised in front of our eyes. Piketty is essentially right, but for the wrong reasons. We can accept his assertion in the book and in many other places that inequalities have been growing for half a century, and we share his view that this is a major threat to the legitimacy of the liberal order, both at the national and the international level. It is another, though not unimportant matter that the epoch between 1910-1970, when measured inequalities were reduced according to Piketty, was far from ideal. This period was burdened with – *inter alia* – the Great Depression, two world wars, and the Iron Curtain.

At the same time, we are deeply sceptical about his central explanation, namely that excessive growth of profits<sup>4</sup> is the fundamental reason for the inequalities which, in turn, slow growth and generate popular dissatisfaction in the long run. Another controversial tendency in Piketty’s work, as Acemoglu and Robinson (2014) and Atkinson (2015) pointed out, is that it overemphasises the privileges of the top 0.1 – 1.0 per cent and their negative impact. This is problematic for two reasons: (i) the places in these elite groups are not long-lasting and not automatically hereditary<sup>5</sup>; (ii) the top 0.1% can influence the political process through voluntary donations disproportionately more than others, so it is important to assess with

1 Published by the Institute of Economics, Centre for Economic and Regional Studies, *Hungarian Academy of Sciences Discussion Papers*, MT-DP – 2016/30, August.

2 See also Mihályi – Szelenyi (2016a, b).

3 E.g., Summers (2016).

4 In Mihályi – Szelenyi (2016a) we deal with the interpretation of the adjective „excessive” at full length. Piketty’s entire argumentation is based on his alleged discovery of  $r > g$ , where  $r$  is the average growth of profits and  $g$  represents the average growth of GDP/head. We show that the  $r > g$  model is a statistical artifact, arising from the intermingling of the concept of profit and rent on the one hand, and capital and wealth on the other.

5 See e.g. Stanley and Danko (1998).

scrutiny what happens to their life-long accumulated wealth at the end: whether it serves good or bad social objectives, to more or less social inequalities.<sup>1</sup>

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The rest of the paper is structured as follows. In Section II, we present something which is so obvious that people tend to overlook it, namely that much of our present inequalities are inherited from the pre-capitalist past and therefore cannot be explained by the general logic of capitalism. In Section III, we revisit Ricardo's theoretical legacy and make the distinction between two sources of inequality: one stemming from profit, the other from rent. In Section IV, we show that the Marxian concept of exploitation was based on the labour theory of value, and Piketty was right when he discarded this concept entirely. On the other hand, we show the way human and social capital play a greater role in the intergenerational transfer of wealth as compared to the inheritance of profit-generating physical capital. In the fourth section, we focus on the economic and social implications of rent-seeking behaviour and contrast it with profit-seeking. Finally, in Section 5, we conclude by stating that rents are not anomalies in advanced market economies. They are among the indispensable building blocks that need to be taken into account both in model-building and policy-making decisions.

## *II. Alternative explanations of economic inequalities*

Before we dwell upon our interpretation of the sources of the *rising* economic inequalities of our times, we make five clarifications pertaining to the past and current *levels* of inequality, which we consider essential, but for the economy of space, we cannot adequately discuss in this paper.

- (i) Pre-capitalist societies were brutally unequal, but they functioned in ways different from the textbook ownership models of 19<sup>th</sup> and 20th-century “classical” capitalism. Inequity, suppression, and discrimination were based almost exclusively on social rank/estate or racial, ethnic, caste, tribal, or clan divisions. All of these positions tended to be hereditary, or to put it differently, based on ascription, rather than achievement. These were the structures that mattered most in the social realm for thousands of years. Nevertheless, one can still find unelected, hereditary rulers on the very top of the social ladder, such as the sheiks of the Gulf States, the kings, and the tribal leaders of many African countries owning the most valuable modern capital assets of their own countries. As far as agricultural land is concerned, more than two-thirds of Africa's land is still under customary tenure, with the right to land rooted in communities and typically neither written down nor legally recognised. In 31 of Africa's 54 countries, less than 5% of rural land is privately owned.<sup>2</sup> Hence, unlike Piketty, we do not believe that the largest part of present-day inequalities can be derived from the “fundamental laws” of capitalism.

<sup>1</sup> Think about *The Giving Pledge* initiative of Bill Gates and Warren Buffet, the well-known American billionaires. Their commitment is to dedicate the majority of their wealth to philanthropy, rather than transferring it to the next family generation. For an impressive list of signatories, see <http://givingpledge.org/>.

<sup>2</sup> *The Economist*, 16 July 2016.

We are deeply convinced that ethno-racial, religious discrimination are still *the* major drivers of relative poverty in large parts of the world. Consider the situation of African Americans or Native-Americans in the US, the fate of aborigines in Australia, the misery of indigenous people in some Latin American countries, the suppression of Muslims by Hindus, Shiites by Sunnites (or *vice versa*), etc. In China, farmers still cannot freely trade the land they use or the houses they own; the *hukou* system still limits the right of hundreds of millions of people to join the urban middle-class. In East European countries, especially in Bulgaria, Hungary, Macedonia, Romania, Serbia, and Slovakia, the Roma (gypsy) population is discriminated. Other types of pre-capitalist social categorisations also remain highly consequential, like in Kazakhstan, where the entire population is “ranked” in three clans (or *jüz* in the Kazakh language). Within-family inequalities need to be mentioned as well, such as the fate of “missing women” in many parts of Asia.<sup>1</sup> Furthermore, as Piketty (2014) himself acknowledges, the principle of primogeniture still exists in many parts of the world: the eldest son inherits all of the family property (or a disproportionately large share).<sup>2</sup>

In the post-communist context, we do not yet have the data to test Piketty’s assertion, but we can accept his point as a valid research question. We can only speculate about how much of the freshly accumulated post-socialist wealth is going to be transferred to the next generation. It is particularly unclear whether the children of the present oligarchs in Russia and China will have the possibility to pass the entire set of property rights to their children, including the right to sell these assets to foreigners or move the family’s financial wealth to foreign countries.

- (ii) In many rich countries, a significant part of the poor is first- or second-generation immigrants.<sup>3</sup> This is – partly – the consequence of the Rodrik (2013) paradox: the bottom 10% of the richest countries earn three times more than the top 10% of the poorest countries. It is disputed what the total effect of migration is on global inequalities. The remittances are of great and increasing significance for many poor countries and contribute to the decrease of cross-country inequalities. They are not negligible even in post-communist countries, for instance, in Poland and in Hungary, with moderate but increasing outward migration.<sup>4</sup>
- (iii) Low incomes arise from low minimum wages to a great extent. But minimum wages, as a percentage of the median wage, vary significantly among the developed countries. In 2013, the legislated minimum wage amounted to 63 % of the average wages of full-time workers in France, but only 39 % and 37 % in the United Kingdom and the US, respectively.<sup>5</sup> In cross-country comparisons, there is a trade-off between higher wage inequality and the level of underemployment among low-skill persons. The problem is even more severe for those not in the regular workforce. In the grey

1 See the seminal study of Sen (1992).

2 *op. cit.* p. 362.

3 In 2013, the foreign-born population accounted for 13.2% of the total population in the US and 9.9% of the European Union. OECD (2015b) p. 17.

4 Mihályi (2014).

5 <https://stats.oecd.org/Index.aspx?DataSetCode=MIN2AVE>, accessed on 7 June, 2015.

or black economy, people can earn incomes from all kinds of *ad hoc* activities, and those incomes never appear in the statistics.

- (iv) All specialists of the subject know that there are intrinsic difficulties in measuring *statistical inequality* in a precise way. In medium-sized and small countries, survey methods are simply not suitable to obtain reliable information on the top 1% or the top 0.1% of the population. For methodological reasons, it is difficult to assess the changes in inequality in the short run, say during the 3-4 years of tenure of a given government. It is very common that the widely used indicators move in opposite directions in such a short time (e.g., the Gini coefficient and the percentage share of people living at a pre-defined poverty level). Although conceptually it is easy to make a distinction between pre-tax and after-tax incomes, in real life, it is difficult to know whether the system of taxation is not sufficiently progressive<sup>1</sup> or the crux of the problem is merely tax evasion (cheating).
- (v) While inequalities are obviously reflected in health outcomes at the society level, ill-health in itself is an independent source of injustice even in the most advanced countries. As a result of genetic heritage, a fatal accident or infection (e.g., AIDS), many people lose partly or fully their wage-earning capabilities for a prolonged period of time, or forever. This and the uncompensated, above-average health expenditures are likely to prohibit these people from accumulating wealth in line with their social peers. This does not have much to do with the political economy of capitalism, either.

### III. Profits versus rents

In the descriptive analysis of our times, Piketty works with a *five-class statistical* model. The bottom 50 % is the lower class, the next 40 % is the middle class, the top 10 % of wealth-owners constitutes the upper class<sup>2</sup>, and this upper class is further divided into the top 1 % and the top 0.1 %. In his explanatory model, by contrast, Piketty relies on the Marxian *two-class political economy model* and takes no full account of the special situation of the self-employed who generate their income both from their own work and the assets they own.<sup>3</sup>

As it is well-known, Karl Marx focused on profit-wage differentials in Volume I of *Capital*. In an attempt to elucidate exploitation, he proposed a model with owners of capital as an ever-shrinking minority and a growing number of wage labourers who only receive the costs of reproduction of their labour power. Piketty accepts Marx's conclusion, according to which there is an overarching, secular tendency for an infinite accumulation of capital, so it is concentrated in fewer and fewer hands. Marx wanted to show that property is not "theft" (Proudhon, 1840). He insisted that in all market exchanges, equivalents are exchanged. It is not the personal greed of the capitalists that drives the institutions of exploitation and the

1 Few supporters of the progressive income tax system know that this idea was first coined by Marx and Engels in the Communist Manifesto.

2 See e.g. in Tables 7.1. – 7.3.

3 This is not a small omission. In 2013, the share of self-employed in the working population was 16.5% in the EU27 and 6.6% in the US. <https://data.oecd.org/emp/self-employment-rate.htm>, accessed on 9 July 2015. For the possible complications arising from this, see Guerriero (2012) paper.

extended capitalist reproduction process. The capitalists do pay the full price of the labour power of the workers (hence the costs of reproduction of labour power) to those whom they employ, but they keep workers working beyond the hours necessary to cover these costs, and they appropriate the surplus created during the extra hours of work.

In a closed economy, under perfect competition, the individual capitalist has no choice. He has to keep wages at the level of reproduction of the labour power, and he needs the surplus (profit) to reinvest in order to remain competitive with other capitalists. Hence, the low wages of the working class and the profit of the capitalists fit into an equilibrium model. Under these circumstances, the expanded reproduction process is a positive-sum game, and Marx also thought in that way, although he obviously didn't use this metaphor. If all profit has to be reinvested, more profit may mean more jobs (or what Marx in mid-19<sup>th</sup> century did *not* consider) higher wages for workers (to generate sufficient demand for capitalist production). John Roemer, arguably the most distinguished "rational choice neo-Marxist", correctly noted: "The neo-classical model of the competitive economy is not a bad place for Marxists to start their study of idealised capitalism".<sup>1</sup> While Piketty expressively rejects the Marxian *labour theory of value* and the *theory of exploitation* following from it, he tends to concur with Marx's followers in the 20<sup>th</sup> century and assumes that – apart from exceptional periods, when governments intervene into the economy with redistributive policies or when wars destroy the accumulated private wealth - wages remain relatively low all the time, while capital keeps increasing. But why does the infinite tendency towards capital accumulation and increasing inequality matter, if the capitalists keep reinvesting the profit in the production process, hence creating more jobs? If expanded reproduction is a positive-sum game for the economy as a whole, what's wrong with it? Marx offered an original answer to this question, which, however, has proved to be wrong: the theory of the declining rate of profit.

Once we step out from Marx's model based on the labour theory of value, we cannot question that cheap technology like computers can have massive productivity gains and hence a rise in national income. This is the explanation why profits in the real world did not decline, the revolution did not happen, and instead the real incomes of workers have increased enormously since Marx's time. One qualification, however, is justified. Profit-maximising behaviour *can* reduce wealth at the national level. A classic example is outsourcing (especially in the case of offshore investments of capital gains), which can cut wages, create unemployment at home, though it still creates wealth globally and tends to reduce global inequality.

David Ricardo ([1817], 2004), who lived two generations before Marx, was convinced that the concept of rent was indispensable to explain the inequalities he observed. As it is well-known, he defined rent as scarcity rent<sup>2</sup>: an income derived from monopolistic ownership of agricultural land (and mines). In his framework, rent seeking was interpreted as a negative-sum game. Rents create no new wealth; rather, they reduce economic growth and reallocate

<sup>1</sup> Roemer (1982) p. 196. Using another metaphor, this idealised capitalism is a win-win situation both for workers and capitalists alike.

<sup>2</sup> In economic textbooks, this is often called „economic rent”.

incomes from the bottom to the top.<sup>1</sup> The importance of contrasting profits and rents is not trivial whatsoever. Already Ricardo noted the absence of clarity in this distinction: (Rent) “is often ... confounded with the interest and profit of capital”<sup>2</sup>

While Piketty is challenging the ethical bases of the observable income and wealth inequalities, he preserves the framework of the mainstream, neoclassical theory of income distribution originally developed by J.B. Clark (1899).<sup>3</sup> Thus, wages and profits reflect respectively the marginal product of labour and of capital. A person’s income is determined by his contribution to production, or more precisely, by the marginal productivity of the “factor of production” to which he contributes. It is a truly zero-sum game, with important consequences:

- (vi) there is no “room” left for rents in the model, or
- (vii) it has to be assumed that rents are paid from profits at the end.

Piketty accepts both explanations, but without saying so.<sup>4</sup> According to him, the neoclassical model is fundamentally right. When wage earners and capitalists fully share the annual national income between them, there is no injustice or exploitation: both classes get what they deserve. There is only one exception in Piketty’s line of argumentation: the compensation of the highest-paid executives of multi-billion-dollar corporations. He does note that these “super managers” receive more than they deserve, owing to their influence and power in the firm where they are employed. But for Piketty, this is merely an undesirable, unnecessary small distortion of the market economy.

### A. *Changing and new forms of rents*

Ricardo believed that agricultural land was despairingly scarce. Hence, its supply is inelastic, while demand for food steadily grows. Under these circumstances the owners of land receive scarcity rent without producing more or better food – i.e. without producing new value. Such rents channel resources away from productive investments and cuts in real incomes of wage and salary earners. In part, Ricardo proved to be wrong, too. First, he did not consider how much the fertility of land can be increased. Secondly, and more importantly, the price/value of agricultural land declined after the inclusion of the Americas and Australia into the emerging capitalist world economy. In fact, even in the 21<sup>st</sup> century there is an abundant supply of uncultivated agricultural land around the globe.<sup>5</sup>

1 As Ricardo put it “The rise of rent is always the effect of the increasing wealth of the country, and of the difficulty of providing food for its augmented population. *It is a symptom, but it is never the cause of wealth*” (our emphasis). (*op. cit.* p. 40)

2 Ricardo (1817), 2004, p. 34.

3 Perhaps this was one of the reasons why his book was so well received in many mainstream macroeconomic departments.

4 Another way of saying what we think is that Piketty (2014) conflates profits and rents and - as Weil (2014), Stiglitz (2015) and Atkinson (2015) pointed out critically, among others, he deliberately disregards the differences between capital and wealth. By contrast, Hodgson (2014) argues that the extended definition of capital which includes cash, bonds, collateralizable assets such as buildings, as well as intellectual property, has analytical advantages as well.

5 Under the FAO’s definition, agricultural land covers only 33% of the world’s land area.

As we have already suggested in Section II, the early high levels of inequalities were driven by two other forces, and not the ones Marx and Piketty pinpointed. (i) In European countries (especially in England), the privileged estate was able to convert its feudal privileges into privileged positions on the market; (ii) Since appropriate mechanisms of market regulations were not in place, it was possible to create monopoly situations (this is what Marx deliberately excluded from his basic model in Volume I of *The Capital*). In some well-noted cases, this type of monopoly or oligopoly was the source of the extraordinary wealth. John Rockefeller is a prime example who by 1900 controlled the production of crude oil, its refineries, transportation, and retail sales. To reverse this state of affairs, it required Theodore Roosevelt's anti-trust regulations, which effectively put an end to his national monopoly through the "criminalisation" of these kinds of institutional arrangements to foster competition.

While socialist countries were believed to be highly egalitarian (that was certainly their legitimating ideology) and indeed inequalities measured in incomes were modest, those with higher rank (high cadres) tended to be over-compensated by various fringe benefits. Hence, inequalities under socialism in their logic resembled those of pre-capitalist societies.<sup>1</sup> Interestingly, the transition from socialism to market economy was partly driven by the same type of forces. Former communist cadres turned themselves into capitalists in the absence of appropriate regulations of the markets. In the early years, distorted domestic prices and austere limitations on consumer goods imports helped many of them to earn their "first one million dollars". This was more so the case in Russia, Ukraine, and other post-Soviet successor states<sup>2</sup> than in Eastern Europe. In Russia today, the high concentration of privately owned wealth is based on the extremely high mark-ups applied in the natural resource sector (e.g. oil and gas). In other nations, the wealth of local oligarchs comes from similar types of rents even today. E.g., in Vietnam, capital control rules prevent foreign companies or individuals from owning more than 49 % of shares in any domestic corporation.

But let's return to Ricardo's theory of scarcity rent. Pareto ([1916] 1935)<sup>3</sup> and the American sociologist, Aage Sørensen (2000), already broadened Ricardo's notion of rent further to include all sorts of real estate and all kinds of monopolies. Stiglitz (2012) also points out that while the scarcity rent does not really apply to agricultural land anymore, it certainly applies to residential property and other real estate. In some urban areas around the world, from London to Moscow, Shanghai, and Singapore, tremendous wealth was generated merely from the scarcity of highly desirable locations and not from productive labour or productive investment of capital. Today, the demand for housing no longer comes from just those people who live in these cities all the time, but from the global wealthy who want to have houses in the above-mentioned globally attractive cities. This private, consumption-oriented wealth

1 Szelenyi (1978).

2 In early 1990, the regulated wholesale price of one ton of crude oil was 30 roubles in Russia, which also happened to be the free retail market price of one package of Marlboro cigarettes. At the same time, the world market price for one ton of crude oil exceeded \$100 – a historically unprecedented arbitrage opportunity. Åslund (1995) p. 42.

3 Pareto in his *The Mind and Society* made an interesting distinction between "speculators" (foxes) and "rentiers" (lions), hence between those who seek profits and those who seek rents. A balanced market economy needs both foxes and lions, dynamism and innovation has to be counterbalanced by stability.

becomes the property of a new urban “aristocracy”, which passes this wealth down from generation to generation. Such wealth, reminiscent of the wealth of land ownership of privileged estates under feudalism, is concentrated. Indeed, its concentration is especially high in the top 1 % or even 0.1 % of the social hierarchy. But we hasten to add, there is a relatively large patrimonial upper-middle class, say the top 10-20 %, which also benefits from all this, if they happen to inherit property in the above-mentioned cities. Moreover, it is worth noting that here a self-reinforcing mechanism works. As the example of London shows in the light of the Panama Papers, the influx of foreigners drives up the property prices, which in turn increases the return of such investments significantly already in the short run.

But is it only land or real estate from which such rent can stem? When we speak of rent-seeking behaviour (as distinct from profit-maximising business investments), we use a broader notion of rent than was customary in the past 50 years of the literature.<sup>1</sup> Max Weber's concept of closure can be a useful way to conceptualise rent in such a broader way. He distinguished “open social relations”, where participation is not denied to anyone who wishes to join, from “closed relationships”, where participation of certain persons is excluded, limited, or subjected to conditions. According to Weber, closed groups manage to monopolise advantages for their party by occupying scarce and desirable positions, or by making desirable goods and services scarce through clientelistic practices, by creating cartels or monopolies.<sup>2</sup> Today, scarcity rent is one of the explanations for the very high compensation packages offered to the best specialists. Firms, as well as universities, hospitals, sports clubs, etc., compete with their peers for stars. They don't want to lose a legendary CEO<sup>3</sup>, a professor, or an athlete to their rivals. It would hurt their prestige and profits. So, they pay more and more, especially in those countries where excessively progressive income taxes do not counterweight such incentives. Closure in itself is not a guarantee for success, neither at the firm level, nor for an individual manager, but it is a great advantage vis-à-vis those who are excluded from the competition.

One of our contributions to the debate on rents is that we believe that it is justified to make a distinction between scarcity rent and solidarity rent.<sup>4</sup> E.g., membership in a trade union reduces wage differentials. While nationwide unions tend to fight for the highest level of employment, branch-based unions fight for the highest possible wages for workers in their branch (and union). Especially, branch unions can push wages in their branch above market wages, hence secure rent to “members”. Through the highly sophisticated institution of collective bargaining, unions prevent the use of wage incentives to pay more to the best workers, teachers, or doctors at the disadvantage of those who underperform. Arguably, the income of those whose jobs are protected by unions or professional associations is composed of two factors: wages/salaries and rents. In developed democratic societies, one of the main functions of such institutions is to create conditions for rents. When the power of trade un-

1 See e.g. Tullock (1967), Krueger (1974), Buchanan *et al.* (1980) and Bhagwati (1982).

2 See Weber (1920) (1978), pp. 43-44.

3 Solow (2014) calls this rent of supermanagers a „sort of adjunct to capital”.

4 In Stiglitz (2015) these two concepts are treated under a single – in our view misleading – heading: *exploitation rent*.

ions was on the rise, solidarity rent helped to reduce inequalities. However, in the context of the globalised world economy, their weight declined<sup>1</sup>, and this in turn was likely to have contributed to the stagnation of real wages for low-skilled manual workers in the manufacturing sectors of many advanced economies, and the US in particular.

Those who collect a pension in a pay-as-you-go system also receive solidarity rent. People who are on social welfare, whose health insurance is paid by taxpayers' contributions, do the same (as distinct from those who are in a funded private pension scheme, or whose health care benefits are paid from private insurance policies). Ideally, fiscal transfers always work as mechanisms of solidarity rent, a transfer from the rich to the poor. But even more is true: given the logic of demand side economics, rents can be economically beneficial since they can maintain or even boost consumption. This is a strong argument for unemployment benefits, but even conspicuous consumption can increase demand, create higher profits and wages, and hence indirectly contribute to wealth generation.

Interestingly, even under socialism, workers collected a rent on top of their wages: they had almost absolute job security. It was very difficult to lay off workers, even those who chronically underperformed, even if they showed up at work drunk. Hence, their income was only partially remuneration for their work; some of the income they collected was almost as "owners" of the collective firm.

Aage Sørensen (2000), whom we have already referred to, offered such a broad interpretation of rent: "Rents are payments to assets that exceed the competitive price or the price sufficient to cover costs and therefore exceeding what is sufficient to bring about the employment of the asset. (...) The existence of rent depends on the ability of the owner of the asset to control the supply".<sup>2</sup> Sørensen also pointed out that the association of rents with land is not required: "Rent will emerge on all productive assets that are in fixed supply and that actors need to maximise their wealth."<sup>3</sup> If we accept this framework, it follows that ownership of potentially rent-producing assets, such as licenses, credentials, access to loans to start new businesses, or to be self-employed, is not restricted to capitalists. Those who do not own profit-generating capital still have the possibility to accumulate wealth in other forms, such as pensions.<sup>4</sup>

1 Between 1980 and 2013, average trade union density fell in the OECD countries from 33% to 17%. This decline is uniform across all member countries, with the notable exception of the Scandinavian countries and Iceland. [https://stats.oecd.org/Index.aspx?DataSetCode=UN\\_DEN#](https://stats.oecd.org/Index.aspx?DataSetCode=UN_DEN#) accessed on July 10, 2015.

2 *op. cit.* p. 1536.

3 *op. cit.* p. 1537.

4 It is noteworthy that in The World Top Income Database, the database underlying Piketty's book, consumer durables and unfunded defined benefit pensions are not taken into account.

Table 1: Piketty's theory in comparison

	Smith	Ricardo	Marx	Stiglitz	Sørensen	Piketty
Source of inequality	Free competition reduces the inequality of feudal privileges.	Scarcity of agrarian land and mines produces rent.	Profit for owners of capital wages for owners of labour power.	Profit for owners of capital and rents for owners of scarce resources.	Control over supply by ownership of scarce assets leads to rent.	Return on capital ( $r$ ) (profit + rent).
Market competition	Perfect.	Competition for scarce land is limited.	Perfect.	Imperfect information and imperfect competition.	Perfect competition for profits vs. wages, imperfect competition for rent.	Perfect competition, except for inherited capital/wealth.
Labour theory of value	Accepted.			Rejected.		
Marginal productivity theory of income distribution	Not known.			Accepts it as a good approximation, by noting that it has become less and less applicable in the last 30 years.	Rejected.	Accepts it as a general rule, but notes that it is less and less applicable to the top 1 % (supermanagers).
Social classes	Three non-antagonistic classes based on ownership of factors of production: labour, capital and land.		Two antagonistic classes based on relations of production owners of capital vs. proletariat.	Non-antagonistic classes based on distribution of income, upper class, middle class, and lower class.	Antagonistic classes, owners of scarce assets are exploiters, those who do not collect rent are exploited.	Three non-antagonistic classes based on distribution of income, (upper, middle and lower), but antagonism between rent-seekers and the rest of the society.
Future of capitalism	Radiant.	May be destroyed as scarcity rent is increasing.	Declining rate of profit and the revolution of the proletariat will destroy capitalism in the most advanced countries.	Progressive taxes on incomes and taxes on rent generating wealth may save capitalism.	No prediction.	Without a global reform of meritocratic taxation, capitalism will become rent-seeking patrimonial capitalism.

Now, we have arrived at the central definition of our paper. We define rent as the difference between what income would have been in an “open relationship” by “closing such relationships to certain individuals or categories of individuals. In simple algebraic form:

*Income from closed relationship – income from open relationship = rent.*

It may be difficult to empirically measure all types of rents, but their existence can be demonstrated through counterfactual reasoning. What would have been the income of a closed group if its members had been competing in open relationships? At first sight, the Weberian concept of „closed” and „open” relationships looks identical to the proposition in Acemoglu and Robinson (2012), who coined the terms „exclusive” and „inclusive” societies. But the two are not the same. The American authors – as the title of their book emphasizes – analyse the growth process at the level of nations. Weber speaks of „closed” and „open” relationships within a given economy – and this is the right approach, if we analyse inequalities within a given country. The same can be said about the dual concept of “*open and limited access orders*” presented in North *et al.* (2012). Nevertheless, we strongly agree with their other assertion about the ubiquitous presence of rent in every society, including the most advanced countries.

Within a well-defined historical-political epoch – say lasting 20-30 years in which average people can make personal comparisons - rents can be temporary or enduring. An entrepreneur who invents new technology may collect rent for a while, but eventually his competitor will invest in the same or a similar technology, and this rent will disappear; the incomes of competing entrepreneurs will be set by the supply and demand mechanism. There are many spectacular examples of this: the success of the Windows operating system invented by Microsoft, the rise of the cell phones, which crushed the privileged position of copper-cable-based telephone companies, or the shale revolution over the past decade, which entirely reshaped the OPEC-controlled traditional oil industry. Following Sørensen (and also Marshall (1920)), we can identify two enduring sources of rent. First, some of the *national* monopoly rents enjoyed by entrepreneurs are created naturally, since the costs of entering production within a given country is often prohibitive due to the increasing returns to scale (e.g., network industries).<sup>1</sup> Rents may be created by governments, by issuing concessions to open mines or licenses to run tobacco and liquor shops. Second, there are personal rents on biological endowments, such as genetic predispositions (e.g., special talent in popular sports or in arts) at the level of individuals, and resource endowments at the level of firms and countries exploiting mineral wealth<sup>2</sup> and other types of geographical advantages, such as access to open sea, sunny beaches, or snowy mountains etc.

The rent-based interpretation of the importance of the natural resource sector can be further generalised. As the Hungarian economist, János Kornai (2013) convincingly argued, in other

<sup>1</sup> In the context of globalisation, however, there is a growing number of companies worldwide in every industry, thus competition is actually increasing at the international level.

<sup>2</sup> For many years the World Bank has been regularly publishing country time series under the label *Total natural resources rents (% of GDP)*, whereby rents are defined as the sum of oil rents, natural gas rents, coal rents (hard and soft), mineral rents, and forest rents. See <http://data.worldbank.org/indicator/NY.GDP.TOTL.RT.ZS>

sectors, such as manufacturing or services, the most important markets are oligopolistic, which allow the most efficient firms to harness higher than average profits through arbitrarily large mark-ups, or, using our terminology, exploiting a scarcity rent. Usually, there are two interrelated factors behind this: pioneering technology<sup>1</sup> and economies of scale arising from the concentration of firms within any given country. While this generalisation may sound idiosyncratic for many economists trained on neoclassical equilibrium models, it is a common place in the management science literature to say that many important industries never have more than three significant competitors.<sup>2</sup> The same trend in the literature also claims that in many markets the shares of the three leading companies reach a ratio of approximately 4:2:1 – i.e., there is a significant market share difference even among the top firms. Data from US Census Bureau also support this claim. E.g., in 2012, the top four US firms' average share of total revenue on a sector-by-sector basis was close to 50% in IT, telecoms and media sector, 40% in retail trade and almost 40% in the finance and insurance sector.<sup>3</sup>

It is very important to underline that state-created monopolies or oligopolies are not necessarily evil, as they are often justified by other social objectives rather than social equity. For example, there are good and widely accepted reasons why intellectual property rights of pharmaceutical companies, individual innovators, and artists are defended by “closure” in the Weberian sense through patents and copyrights. It is not surprising that Aghion *et al.* (2015) found positive and significant correlations between innovativeness in the US on the one hand, and top 1% income shares on the other. Similarly, it makes a great deal of sense to require state permission for firms to build nuclear power stations, or even simple two-storey houses. It is also in the general interest that physicians have to acquire a special occupational license (e.g., a university diploma) before they can start treating sick people. Other types of regulations (e.g., land use by-laws in urban areas) can be assessed, if at all, on a case-by-case basis only.

## *B. Institutional consequences of rent*

If the rise of rents begins to match or even overtake the growth of incomes from profits and wages, this can have major (often unintended and undesired) institutional consequences. We can think of at least two such institutional consequences. Firstly, certain type and some level of rent are necessary for social cohesion and innovation in society. Such rents may be seen as “deserved”, but at one level, they are still “unearned”. The major legitimacy claim of market capitalism is meritocracy. At one point, rents generated by any means can be seen as “excessive”, if public opinion judges it of too much” for those who “did not work for it”. Most people accept some rent to drug manufacturers/innovators, but there may be a ceiling how much is seen as “reasonable” and how much is judged as “exploitive”. Same goes for

1 This is a temporary advantage, as we explained earlier.

2 This finding was first demonstrated by the founder of the Boston Consulting Group, Bruce Henderson (1976) and then later re-confirmed empirically on a much larger data set by Reeves *et al.* (2012). Since then, successful companies, like General Motors and others live according to this maxim. If they cannot become Number One or Two in an industry, they get out from that market and reinvest their resources somewhere else.

3 See *The Economist*, 26 March 2016.

social benefits. In civilized societies most people accept that the poor (or disabled) should have some social support – even if it is “unearned” –, but at one point it may be judged to be “far too much”. Even in the US the most sacred social institution like Social Security has been challenged – so far unsuccessfully. Should Social Security be “privatised”, hence turned it from “rent collection” to “profit incomes” on deposits made during lifetime? This is an often-discussed alternative to the present arrangement, although given the broad political support for Social Security, it is likely to remain the sacred cow of US politics.

Secondly, if the wealth of individuals comes increasingly from rent rather than wages or profits, there is little institutional incentive that rent will be reinvested most efficiently. The *nouveau riche* or the inheritors are tempted to waste the rent they collected: Easy come, easy go. Profit-maximising entrepreneurs tend to invest their profits in optimal ways to fight off competitors. Rent collectors don't face competition; rent can be spent as “conspicuous consumption”. The *nouveau riche* entrepreneur tends to use a chauffeur-driven Mercedes or private plane well before they can afford it. The second and especially the third generation “inheritors” may spend their inheritance in good case on charity, in bad case on conspicuous consumption. Absence of the institutional mechanism of owners of wealth to use it most efficiently can have devastating social and economic consequences. It can lead to state failure and economic stagnation or even collapse.

### *C. Class reproduction through the accumulation of human and social capital*

The educational system is an important terrain of closures, as defined by Max Weber. Given the high costs of education, especially of elite education, access to the most highly valued education may not be open to all, but it is closed to youth whose parents cannot afford the often prohibitive costs.

This is particularly prevalent in the US. At Ivy League universities, youth from white upper-middle and upper-class families are overrepresented despite all efforts to support the children of less privileged families. One obvious mechanism is strictly achievement-based entrance exams, where the children coming from more affluent families simply outperform those who arrive from average families. It is less obvious that the recent trend for US colleges to admit students not just on the basis of intelligence, but based on being “well-rounded” (i.e., having taken ballet classes, performed in plays, founded clubs, volunteered time helping handicapped children, etc.) works in the same direction. Whereas there is some randomness in the distribution of intelligence, all these extracurricular activities are things that only very upper-middle-class, private school children can do.<sup>1</sup> In sum, inheritance is another market-based institution that creates rent for the inheritors. This can be inheritance of wealth (even just valued real estate) or social status linked to education in elite universities.

The experience of the United States, in many ways the pace-setter of the capitalist economic system, shows that family formation through assortative mating further strengthens these

<sup>1</sup> The authors are grateful to Daniel Treisman for this observation.

tendencies.<sup>1</sup> Since educated men tend to marry educated women more often than two generations ago, this inevitably leads to a concentration of income and wealth, which in turn helps these “privileged” parents to invest time and money in the future of their children literally from the day of their birth. Children born in families where both parents (and perhaps even grandparents) hold a university degree are outcompeting their less fortunate peers throughout the education ladder and later on the job market. This is the main institutional channel through which social inequalities are regenerated, and hence patrimonial capitalism is taking more and more ground, not so much for the top 1 %, as Piketty suggests<sup>2</sup>, but for the entire upper-middle class. Three successive cohort studies of 70 thousand children born in the UK in 1946, 1958 and 1970 showed that childhood circumstances determined by the social status of parents profoundly influence lifetime inequalities in spite of all the welfare measures introduced by successive British governments.<sup>3</sup>

There is an additional mechanism of closure in the educational system, and that is credentialing. Education is often conceptualised in terms of human capital investment. It is usually assumed that human capital invested in education will lead to productivity gains and higher incomes for the better educated results from such productivity gains. But especially powerful professional associations (such as the American Medical Association, or the American Bar Association) requiring bar examinations play a role in controlling the supply of occupations under their jurisdiction, hence they may drive up incomes for those occupations by adding a rent to their income from work.

The emphasis on credentialing (rather than just on education or training) may have consequences for what kind of knowledge will be required from candidates seeking valued credentials. Not all knowledge required to pass critical exams will have productivity gains; it may be just knowledge that is useful to screen candidates for such credentials. This is what Bourdieu (1970, 1977) called “cultural capital” as distinct from “human capital”. Cultural capital serves more the purposes of the reproduction of the “patrimonial middle class”, or “patrimonial upper class”, rather than increasing the productivity of the graduate. For parents, it may cost as much as \$300,000-\$400,000 just to get their children an Ivy League BA or BSc – but the descendants’ Ivy League degree will pass on to them the status of “nobility”. Employers will seek Ivy League graduates not necessarily because their technical skills are better, but because hiring such people will add to the prestige of their institution.

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There is no need to list examples to show that the term rent is used with different meanings not only in common parlance, but also in the scholarly literature. In this section, we tried to delineate the various types of rents and their characteristics. In the spirit of Ricardo, Weber, and Sørensen, we consider all incomes as rents if they stem from ownership of *any* assets, where access to such assets is closed for other economic actors. Our list at present comprises

1 Greenwood *et al.* (2014).

2 *op. cit.* 485-486.

3 Pearson (2016)

9 forms of rents, but it is not exhaustive. Depending on the institutional setup of different countries, additional categories could be included.

Table 2: Rents extracted in advanced market economies by firms and individuals

		TIME HORIZON		FAVORABLY MOSTLY FOR	
		Temporary	Enduring	Owners of for-profit firms	Ordinary individuals
... without direct state involvement					
1	Innovative technology	x		x	
2	Positional goods and services (e.g. agricultural land*, real estate, honoraria of art and sport celebrities)		x	x	x
3	Natural monopolies based on economy of scale and scope (e.g. network industries, shopping malls)		x	x	
4	Limits to market entry by professional organizations (e.g. lawyers, doctors)**		x		x
5	Cartel agreements		x		x
... with direct state involvement					
6	Copyrights and other sorts of protection of intellectual properties (e.g. pharmaceutical industry)	x		x	x
7	Solidarity rent (e.g. collective bargaining, welfare payments)			x	x
8	Limits to market entry through licensing (e.g. medical profession)		x	x	x
9	State capture (e.g. discriminative lawmaking, tainted public procurements)		x	x	

Notes: \* First analysed by D. Ricardo. \*\* First analysed by A. Smith.

### *Consequences of inequalities*

Before we move further, let us put the institution of rent in brackets for a moment, as if it didn't exist, because we do not want to underestimate the importance of relative dynamics in the movements of profits and wages. As long as wages are on the rise, this is a positive-sum game, as we argued above. Neoclassical equilibrium models are all based on this assumption, which was perhaps not very far from reality until recently. Globalisation, however, has brutally changed the outcome of the game.<sup>1</sup> While profits have been rising in many sectors of

1 See Solow (2015) which bluntly acknowledges this.

the US, Germany, and other big economies, real wages in the same sectors were stagnating as a consequence of – *inter alia* - outsourcing and the growing share of the financial sector. Hence, we agree with Piketty that today the wage-profit relationship in the advanced Western countries could become a negative-sum game for low-skilled workers and employees, which in turn fuels populist sentiments against globalisation, migration and the highly educated, highly paid business executives.

Having said this, we assert that the profit - wage inequality is only loosely related to economic growth or social stability. In some societies – in the United States, for instance – high inequalities are accepted, and the US produces relatively fast growth and social stability with a GINI over 0.40. Some other societies (in Scandinavia, for instance) do not tolerate inequality well, but they can still produce good growth rates and great social stability. In contrast to Piketty's main line of argumentation, we contend that voters and political activists are chiefly concerned about *personal inequalities* of income around them, and much less about the concentration of economic wealth and power in the form of publicly traded shares or family-owned companies – i.e., the wealth *proprement dit* of capitalists in a class-based model. While it is true, that sensational formulations, such as “48 % of the world wealth is owned by 1 % of world’s population”<sup>1</sup>, can easily catch the attention of the media and through the media these numbers stuck in the memory of social scientists – including Piketty, who often quotes such data -, these “facts” are not mobilising ordinary people. In other words, most people are agitated not because of the gap between businesspeople and wage-earners, but rather because of the large variation of employee wages. Typical cases are when the salaries of doctors, teachers, or policemen are compared to the salaries of bank managers or widely known celebrities in the area of sport or music, or minimum wages are compared to the minimum cost-of-living. This is one type of scarcity rents, as we explained above. Thus, we cannot leave out rents from the argumentation.

The current argument that can be seen as running counter to Piketty is that increasing levels of inequality do not necessarily lead to political instability. Important counterexamples can be observed both in Western and post-communist democracies and post-communist authoritarian regimes. The disprivileged poor are inclined to abstain from voting in elections. This holds for such divergent countries as the US or Hungary, and the political elites are fully aware of this. In a vote-maximising strategy, pro-poor policies simply don't pay off. In authoritarian China, where elections are largely ceremonial, inequalities skyrocketed, but so far, the popular response has been mute. Since 1978, economic growth has been phenomenal. The boats of hundreds of millions were lifted out of poverty with the rising tides, even though at very unequal speeds. So, people might have accepted more inequalities as long as their prospects for a better life seemed secure. Martin Whyte (2010) found that inequality

<sup>1</sup> Oxfam (2015), the renown charity timed the publication of its fresh research for the opening of the Davos economic summit, and skillfully captured the headlines of many newspapers. Another sensational formulation of the same report was that “85 richest people on the planet have the same wealth as the poorest 50% (3.5 billion people)”.

was not a major concern for the ordinary Chinese. Russia had similar experiences during the first few years of the 21<sup>st</sup> century.<sup>1</sup>

Furthermore, everyday experience as well as academic research show that ordinary people have little idea about the true (i.e., statistically measured) size of inequalities in their own countries. Gimpelson and Treisman (2015) demonstrated on a variety of large, cross-national surveys that what people think they know is often wrong. In their list of 40 countries, the “least correctly informed” people are the citizens of 8 post-communist countries (Ukraine, Hungary, Croatia, the Slovak Republic, Estonia, Poland, Slovenia, and the Czech Republic); while on the top of the list we find two rich welfare states (Norway and Denmark).<sup>2</sup> Moreover, they showed that the *perceived level of inequality* – and not the actual level – correlates strongly with the ideologically motivated demand for redistribution and the reported conflicts between the rich and the poor.

What really annoys people – ordinary people and social scientists alike – is the knowledge or the presumption that the successful entrepreneurs and especially the most successful ones, are greedy, dishonest and corrupt. In the North American media, during the recent financial crisis, “Main Street” represented the interests of everyday people and small business owners, in contrast with “Wall Street” (in the United States) or “Bay Street” (in Canada), symbolising the interests of highly paid managers working for large banks and corporations. In Southern European countries, like Bulgaria, Romania or Greece, where rent seeking, managed by government is especially common, this can be seen as an important reason for political instability and the strikingly low trust in market institutions as such. Under particular historical circumstances, rent seeking may have devastating consequences to economic performance and brutally negative impact upon the society (e.g., Venezuela, Brazil).

As we have already shown in the example of Ricardo’s failure to predict “scientifically” the rise of scarcity rent for agricultural land, it is inherently impossible to predict the future trends of other types of scarcity rents, too. The last 20 years exemplified that rents on oil- and gas extraction can vary enormously, and with this, the relative income position of the workers as well. The same explanation holds for the case of Norway and the UK, if compared to France or Italy. In Central and Eastern Europe, the “free” money flowing from the European Union has been the chief motivation of rent-seeking practices of those firms, individuals, local governments, etc. which feel themselves close to the centre of political power, where access to EU-funds is controlled.

1 The Mihályi – Szelenyi (2016b) paper is entirely devoted to the role of rents in the transition process from the pre-1989 socialist to the present-day capitalist system.

2 The list was compiled from a questionnaire where people were asked to select the income distribution diagram with the Gini coefficient closest to the actual one for their country in 2009. At the top, 61% of Norwegian respondents chose correctly regarding the distribution of post-tax-and-transfer incomes, while in Ukraine, only 5% of respondents answered correctly.

## Conclusions

It is often left out of the narrative that while *intra-country* inequalities have been rising, globalization significantly decreased the *inter-country* inequalities due to the large population weight of China and India, as opposed to the relatively small weight of many very small, but very poor African countries. Rising international competitiveness of these large economies (as well as the successful post-communist member states of the European Union) has a depressing effect on the real wages of the median blue-collar factory workers in the older market economies. The rise of wages in the developing countries is the cause of the wage stagnation in the developed countries – these are the two sides of the same coin.

Our main inference in the present paper is that the crucial question is not the extent of measured inequality (income or wealth). Countries with GINI around 0.20 or 0.40 can equally be economically dynamic and socially cohesive. Beyond the still remaining pre-capitalistic, ethno-racial, religious, gender-based pay gaps, etc. described in Section I, our key political economy question is what mechanism generates inequality in the business sector: profit-seeking or rent-seeking. The statistically measured changes in the distribution of wealth at the society level cannot be explained by the fluctuations of profits, as Piketty contends. Since the 1970s rents have played an increasingly important role. Our second assertion is that rents are not anomalies in liberal market economies. They are time and again generated by governments or other collective agencies in the workings of free markets. To a large extent, they are unavoidable and indispensable, while at the same time, they are potentially dangerous for the system's stability. Hence, our contribution to the current literature is the reintroduction of the Ricardian concept of rent in a predominantly value-neutral manner.

In other cases, rents are destructive. There are two main institutional arrangements along these lines: state capture by private businesses and market capture by political elites. These are obviously harmful phenomena and may threaten the legitimacy of such regimes and/or undermine their economic efficiency. Nevertheless, unlike Ricardo and much of current economics literature, we interpret rent broadly (in the spirit of North, Wallis, Weingast and Sørensen). Rent originates not only from ownership of land, mines, and real estate, but from ownership of any asset which is scarce, either "naturally" or made scarce by insufficiently regulated markets or state intervention in favour of clients.

Piketty's book suggests a gradual shift from progressive income tax<sup>1</sup> toward progressive wealth and inheritance taxes. Beyond a certain amount of relative wealth (defined in the context of a given country) our distinction between wealth emanating from profits or rents is not relevant, hence such reforms are sensible for us, too. This may call for lower tax rates on incomes, profits and consumption (VAT) and higher tax rates on inheritance and capital

<sup>1</sup> Few supporters of the progressive income tax system know that this idea was first coined by Marx and Engels in the *Communist Manifesto* (1848).

gains. For sure, the fact that current tax rates are extremely low in the OECD countries allows huge manoeuvring room for future change.<sup>1</sup>

Finally, when discussing inequalities, it is a mistake to focus on the wealth of the top 1 % or 0.1%, as Piketty does, because the positions in these elite groups are not long-lasting and not necessarily hereditary. Through the combined effect of accumulated human and social capital, higher per capita incomes, inherited real estates, and assortative mating, the yawning gap between the families of the top 20 % and the rest of the society is much more upsetting. There is a great deal of irony in the fact, that readers and enthusiastic supporters of Piketty's book who likely belong to the patrimonial upper class, the top 20 % of their own countries everywhere, are so irritated by the wealth of the top 1 %. As Robert Solow maliciously noted, there is a relationship between this biased focus of the Piketty book and its phenomenal international success: envy is a more powerful emotion than compassion.<sup>2</sup>

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1 In 2012, the combined revenue from all kinds of property and (net) wealth as a percentage of GDP was in the range of 0.3% (Estonia, Mexico) and 3.9% (UK). <https://stats.oecd.org/Index.aspx?DataSetCode=REV> accessed 9 July 2015.

2 Robert Solow in Conversation with Paul Krugman: "Inequality: What Can Be Done?", 1 May, 2015 <https://www.youtube.com/watch?v=DGmUtJkTaqc>

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### 3. The Role of Rents in the Transition from Socialist Redistributive Economies to Market Capitalism

#### *Introductory remarks<sup>1</sup>*

In the first part of the paper, we review how wages, profits and rents are treated in classical social theory. We show the unique contribution of Ricardo (1817) to the theory of rent, and we conclude with a brief discussion of Sørensen's (2000) Weberian reinterpretation and generalization of Ricardo's theory. Like Sørensen, first we define rent as an income gained from closed relationships, from monopolies, cartels and regulatory capture. Then we make two qualifications: (i) while literature in the past 50 years considers whether all or some form of rent-seeking shall be interpreted as corruption – see e.g. Tullock (1967), Krueger (1974), Posner (1975), Buchanan *et al.* (1980) and Bhagwati (1982) -, we use the term in value-neutral terms; (ii) we will argue that rents and rent-seeking behavior are present in all economies.

Our point of departure is Piketty (2014) and Stiglitz (2012), who see inherited wealth from profits as responsible for much of the increase in social inequalities in contemporary capitalist economies, hence the making of patrimonial capitalism. Our hypothesis is that rent seeking was especially present in post-communist capitalisms, given the pressure of fast privatization of state-owned assets. In some countries, such as Russia, China, or even in Hungary, the significance of rent seeking and the role of politics in the allocation of public funds are increasing. In these countries, politics remains in control. It is not big business, which captures the state; rather, the state captures the market and plays a critical role in the making and unmaking of the new rich.

In conclusion, we evaluate the consequences of the increase in rent seeking. The inequalities created by profit and wages are vast but can be addressed by the imposition of progressive taxation. Taxing of rent (taxes on inherited wealth and capital gain being one of the prime examples of such rent) is likely to meet powerful resistance from interest groups.

#### *Rent in Classical Economic Theory*

From John Locke to Adam Smith, David Ricardo to Karl Marx, classical economic theory has always struggled with the role labor, capital, and rent play in the creation of value, and the determination of prices and incomes. The normative wisdom of 18<sup>th</sup>/early 19<sup>th</sup> century economics was the “labor theory of value”. Although few economists would accept this theory today, once rents are defined as a part of profits the distribution of revenues exclusively between wages and profits is still often a common point of departure.

<sup>1</sup> The first draft of this paper was finalized in April 2016. The final version was ready by December 2016. First published in *Comparative Sociology* (Vol. 16. 2017. pp. 13-18.). The article was republished in Ivan Szelenyi: *From State Socialism to Post-Communist Capitalism. Critical Perspectives*. Harrassowitz Verlag, 2023. Wiesbaden, pp. 263-285. ISBN: 978-3-447-11858-3.

Adam Smith, much like Locke, explained the origins of rent from the private ownership of land and mines. However, he had a lingering doubt about how much landownership contributed to the creation of new wealth, writing: “*as soon as land of any country has all become private property, the landlords .... love to reap where they never sowed and demand a rent for its natural produce*” (Smith, 1976, p.56, our emphasis). Ricardo moved substantially beyond Locke and Smith, arguing: “*the rise of rent is always the effect of the increasing wealth of the country, and of the difficulty of providing food for its augmented population. It is a symptom, but it is never the cause of wealth*” (p. 40. our emphasis). While for Locke and Smith wages, profits, and rent all contribute to the value and price of the products and to the wealth of the nation, Ricardo only sees such a productive contribution of wages and profits. Rent – at least rent which comes from the scarcity of land – is not the cause of value/price, or wealth, it is the consequence (symptom) of increasing prices/wealth. Smith and Ricardo were liberals; they advocated capitalist transformation of society. As we will elaborate on in the following section, Smith’s lingering doubts about and Ricardo’s explicit criticism of rent do not follow from the “general logic of capitalism”. Ricardo offered a general – not historically specific – theory; nevertheless, it can be interpreted as a criticism of landed aristocracy. Ricardo’s “scarcity rent” is “unearned” income, which does not contribute to wealth creation; it indeed redistributes incomes from wages and profits into rental revenue.

By 1867, Karl Marx was confronted with a different social world, one of industrial capitalism; therefore, he attempted to frame a theory of general laws of capitalism. Industrial capitalists and capitalist landowners had to share the profit they expropriated from labor. In Volume I of *Capital*, the focus is on wage versus profit, which should be demonstrated as a negative-sum game, to offer a scientific explanation of why capitalism must collapse. Although this idea led Marx to the elegant theory of “exploitation,” we argue that he did not achieve this aim. Instead, Marx produced an equilibrium theory of the capitalist economy, which was better suited to explain the iron law of the reproduction of capitalism rather than its inevitable collapse.

Marx’s point of departure is this: “*The conversion of money into capital has to be explained on the basis of laws that regulate the exchange of commodities, in such a way that the starting point is the exchange of equivalents*” (Part II of Volume I, Marx 1954, p.161. Our emphasis). But at the end of the production process, the capitalist must have more capital than it had when the production cycle began. Marx succinctly describes the logic of the capitalist production cycle with a simple formula: M-C-M’. The capitalist production process begins with capital (money), followed by the purchase of commodities, eventually selling the product of these commodities for more money, hence accumulating capital. There are two important questions for Marx. (i) If we have to assume that equivalents are exchanged (no one cheats nobody (Vol. I. p. 161), how can the miracle of gaining more money at the end of the cycle occur? (ii) What does the capitalist have to do with the accumulated capital?

For the first question, Marx offers an elegant, though somewhat Talmudic explanation. The price of labor power is the same as the price of any other commodity: hence, the costs of its reproduction. The trick is that labor power is the only commodity that produces more value than its own when consumed. The worker can produce enough value in x hours to cover

his costs of reproduction (which even includes the costs of production of the next generation of workers, the costs of raising their children). However, since the worker's labor power is now under the control of the capitalist, the capitalist will require the worker to work  $x+y$  hours. Could the capitalist pay their workers less than the value generated during  $x$  hours? No, since in this case, the worker would not be able to continue producing and the working class would starve. Could the capitalist pay the worker more than the value, and share some of the value created working hours  $y$ ? (a "generous" capitalist?) No, since in this case, if the worker starts accumulating capital, they will eventually become capitalist and stop selling their own labor power.

But this leads Marx to the second question: what will the capitalists do with  $M'$ ? Capitalists compete with each other. If a capitalist chooses not to invest in expanded production, he will be destroyed by competition. This is indeed the "satanic mills": the worker, derived from the means of subsistence has to sell their labor power, cannot collect less or more than the costs of reproduction of their labor power, and the capitalist has no choice but to use the profit (named surplus by Marx) expropriated from their workers to reinvest, expand production and/or improve productivity.

Marx was searching for a scientific theory to explain why capitalism must fall, but if we eliminate his heated word choices ("money bags"), the exploitation theory of Volume I only explains why capitalism will never fall. John Roemer, arguably the most distinguished "rational choice neo-Marxist" was right on the dot when he stated: "*The neo-classical model of the competitive economy is not a bad place for Marxists to start their study of idealized 1 capitalism*" (Roemer, 1982, p. 196). In the third volume of "*The Capital*", Marx made an effort to find the scientific proof for the fall of capitalism. He formulated another fascinating, but logically incomplete and empirically dubious hypothesis of the "tendency of the rate of profit to decline." Marx was aware that there are "counteracting tendencies" (though surprisingly he did not elaborate on the most important "counteracting tendency": namely that productivity increase from technological innovations can be far greater than the costs of investment into constant capital), so he left the manuscript unpublished and arguably it was Engels who turned the declining rate of profits into a "law" which explains the inevitability of the demise of the capitalist mode of production.

Our interpretation is that when Marx could not persuade himself that he had found the scientific theory he was looking for, he turned his attention to ground rent. For Ricardo, the rent of landed property was distinctly different from capitalist profits. Marx's lengthy and somewhat difficult to digest description was of rent as a feature of market capitalism (See, especially Marx, pp. 773774 and pp.782783). Nevertheless, much to his horror, in Chapter 52 Marx realized he had returned to Adam Smith: "*The owners merely of labor-power, owners of capital, and landowners... constitute then three big classes of modern society based upon the capitalist mode of production*" (p. 885). The powerful two-class model of bourgeoisie versus proletariat is now replaced with a three-class model where wages, profits, and rent are just three different sources of income. Therefore, the inherent equilibrium tendency of the ex-

<sup>1</sup> The term idealized is important. As we know, the major shortcoming of neo-classical economics is that there are no perfect markets in any "actually existing" capitalist economies.

ploitation theory is not resolved. Marx finished the page and left the manuscript incomplete and left Volumes II and III "to the gnawing criticism of the mice"<sup>1</sup>. We believe Marx moved in the wrong direction and lost the important insights Ricardo had already offered into the differences between profits and rents.

### *Closed and open social relations*

Max Weber made a captivating distinction between "open" and "closed" relationships. As is the case with most Weberian concepts, this is part historical, part analytical. History tends to move from more closed to more open relations, but even in contemporary societies, closed and open relations coexist and complement each other. "*Social relationship... will be spoken as 'open' to outsiders if and insofar as its system of order does not deny participation to anyone who wishes to join and is actually in a position to do so. A relationship will ... be called 'closed' against outsiders so far as... participation of certain persons is excluded, limited or subjected to conditions*" (Weber (1978) p. 43.).

In pre-capitalist, agrarian economies, the dominant form of socioeconomic organization is based on closed relations. Economically speaking, an organization revolves around "household" economy (*oikos*), which operates as a budgetary unit. The feudal landlord's or the slave owner's revenue is rent, the prime examples being revenue stemming from closed social relationships. Feudal landlords and slave owners "are typically rentiers" who extract products of labor or labor services from serfs and slaves, and in exchange, guarantee their subsistence. Slaves and serfs typically do not earn wages, and either have the right to grow their own food or be fed, clothed, and housed by their lord or master. The "surplus value" extracted this way is typically not reinvested for profit maximization purposes, but instead it supports the usually luxurious lifestyles of the court, or the household of the landlords and slave owning masters.

Weber's distinction between private wealth, operating as landed estates, as *oikos*, budgetary units and capital, the profit-making enterprise, is of far-reaching importance. As long as the economy is dominated by landed estates, budgetary accounting – as was the case in the ancient world and under Western feudalism (and to some extent under state socialism) the development of capitalism and dynamic economic growth was greatly limited... "*The person who is a mere rentier...is...not engaged in profit making.*" (p. 99) An economy not dominated by profit-making enterprises will become stagnant. Even medieval urban economies in the ocean of rural countryside followed a similar logic – that trade and artisanship were organized by guilds, a strictly closed organization. Entering a guild was an arduous and highly selective

<sup>1</sup> Marx wrote this about the German Ideology in *A Contribution to the Critique of Political Economy* (1857), but it is reasonable to assume that he found Volume II and III equally incomplete, not ready to be printed. It is especially telling the Volume III, Chapter 52 which was supposed to be the grand conclusion is left incomplete on the second page.

<sup>2</sup> This is a very interesting qualification. Weber tries to avoid the Marxian trap, namely that workers since they do not have capital by definition cannot enter competition. He narrows competition to those own capital and who are wage earners.

apprenticeship process, which lasted for many years and depended upon family connections. Guild members' revenue can be conceptualized as composed of wages/profit + rent. Most guild members (e.g., Hans Sachs in *Die Meistersinger*) physically produced goods, earned a "wage" from this service, ran a business, and often exploited or abused their apprentices while collecting profits from their work. However, as guild members monopolized the trade, they undoubtedly sold their products at free market determined price, hence they collected rent.

Is it only land or real estate from which such rent can stem? As the example of the guilds shows, the answer is no. According to Weber, closed groups manage to monopolize advantages for their party by occupying scarce and desirable positions, or by making desirable goods and services scarce through clientelism, by creating cartels, oligopolies, and monopolies.<sup>1</sup> Today, rent is one of the explanations for the very high compensation packages offered to the best specialists.<sup>2</sup> Firms, as well as a variety of institutions, such as universities, hospitals, and sports clubs, compete with their peers for celebrity endorsement. Losing a respected CEO, a famous professor or a successful athlete to rivals diminishes opportunities for prestige and profits. Therefore, institutions pay more and more, especially in countries where excessively progressive income taxes are not an obstacle to such incentives.

Scholars from Kuznets (1955) to Piketty (2014) argue that inequalities were modest in early stages of development, increased with industrialization, and then later began to decline (Kuznets's inverted U-curve). Nevertheless, many economists and sociologists, including Piketty, detected the reemergence of inequality after the 1970s. Although we do not have reliable data for pre-capitalist times, it is safe to assume that the nature of inequality before capitalism was of a different kind, mainly driven by rent rather than by profit. Also, the extent of inequality was substantially higher and more rigid than under capitalism. Class inequality under the worst case of capitalism must have been trivial in comparison with inequalities between slave owners and slaves, landlords and serfs.

Let us make a brief remark on socialism. In communist ideology, socialism was usually defined as a transition stage between advanced capitalism to communism. This proved to be historically and empirically incorrect. Socialism was a transition from feudalism to capitalism. Workers under socialism were neither slaves nor serfs, but they were not wage laborers either, selling their labor power on competitive labor markets. They operated in "closed" social relations; they were not free to decide whether they worked or not, nor could workers negotiate their wages. Under these circumstances, there was little, if any relationship between their productivity and remuneration. Neither employers nor employees were actors on the labor market. In classical socialism, labor was allocated through a non-market trade of labor. Under socialism, social relations were not class relations, but rather, relations among status groups. Actors were slotted into the hierarchy of status groups according to three credentials (education, party membership, and position in the nomenclature) and incomes were centrally controlled and defined accordingly (Kornai (1992), pp. 216227).

1 See Weber (1920) (1978), pp.4344. Clearly, all this is very close to the concept of Acemoglu – Robinson (2012).

2 Solow (2014) calls this rent of super managers a „sort of adjunct to capital”.

“Public ownership,” while partly fictional, had a rational element as well. Since the socialist economy was an economy of shortage, not only was full employment guaranteed, but all positions, from unskilled workers to top management, were practically “tenured”. Once workers entered a status group (*Stand*), they could not be fired and had a chance to be promoted to a higher status group. If a worker received new credentials or was admitted to an in-group, he/she joined the communist party. The employees had *de facto* property rights in the assets of the firm/organization. They were employed as proprietors, and they collected “rent” even if they did not contribute anything to the productivity of the firm/organization. What one received over the minimum in their status group could be seen as wage or profit, with the qualification that, given the semi-feudal/socialist character of the system, this higher income did not necessarily reflect a greater contribution to productivity but might have instead been a reward for loyalty. We know little about the true extent of inequality under socialism. In most scholarly writings, inequality is often underestimated, as fringe benefits were not taken into consideration. In general, socialist economies were relatively egalitarian, more so than feudal or most capitalist economies. In terms of the logic of inequality, social economies were closer to pre-capitalist formations than to market capitalism.

### *Interpretation and generalization of Ricardo’s theory of rent by Sørensen*

In his groundbreaking article, Aage Sørensen (2000) reinterpreted and generalized Ricardo’s Theory of Rent. The Sørensen article was cast as a debate with Erik Olin Wright’s Class Theory. Wright, in the classical traditions of Marxist theory, conceptualizes exploitation as the basis of fundamental class division between profits and wages. In this interpretation, Marx’s profits vs. wages model is a zero-sum game; what capitalists gain, the workers lose. Hence, their relationship is antagonistic and will eventually lead to the revolutionary overthrow of the capitalist order. In contrast, Sørensen sees rents vs (profits + wages) as a zero-sum game, where he defines rent as income stemming from closed relationships (in the Weberian sense of the term). As neoclassical economists would argue, this income is higher than the income would be in perfectly competitive markets. Sørensen calls such rental income, exploitation (Stiglitz uses the term “exploitation rent”) and sees it as a measure of class divisions.

In this paper, our point of departure is Sørensen’s Theory of Rent, but we choose not to take a position on whether rental income is exploitation. This is the distinction between rent-earners and others as class relations, identifying antagonism in relationships between rent-seekers and profit maximizers. Our aim is modest; we follow Sørensen and use a broader notion of rent than that of Ricardian theory. Thus, rents are all incomes stemming from ownership of any assets where access to such assets is closed (through oligopolies, monopolies, cartels, or state regulations) from some actors.

Inequality stemming from profits vs. wages is a moral and political problem. We do not underestimate the importance of these inequalities. In each liberal democracy, given the value system of society, the citizens decide how much inequality is acceptable and how much income or wealth from the rich shall be redistributed through taxation. However, inequalities from rents originating from closed relations pose unique challenges:

- (i) a legitimization problem of liberal capitalism, which claims to be meritocratic; and more importantly,
- (ii) they may undermine the most effective allocation of resources.<sup>1</sup>

Mancur Olson (1982) described historical instances when rent-seeking behavior, which captured state regulations or licensing, led the state collapses. Specifically, in open social relations (perfectly competitive markets), as long as the sum of profits + wages is growing, this is a positive-sum game for society. If rents are growing faster than the sum of profits + wages, this is a negative sum game (Stiglitz, 2012). According to his opinion, “*in the aftermath of the financial crisis, no one today would argue that the banker’s pursuit of their self-interest has led to the well-being of all. At most, it led to the banker’s well-being. (...) It was a negative sum game, where the gains for winners are less than the losses to the losers. What the rest of society lost was far greater than the banker’s payoff. (...) When the market works well – in the way Adam Smith hypothesized – it is because private returns and social benefits are aligned...*” (p. 41)

So far, we described the Weberian distinction between closed and open relations in historical terms, but as we previously argued, it is also an analytic distinction. Weber does acknowledge – much like Adam Smith, that, in modern capitalist economies, incomes come from three different sources: wages, profits and rents (Weber, 1978, p. 205). His evaluation of the three sources is the most interesting one: “*Of all types of incomes, it is particularly those from business profits and the contracted piece rate or free labor incomes which have a dynamic, revolutionary significance for economic life. Next to these stands incomes derived from free exchange and, in quite different ways, under certain circumstances the ‘predatory’ incomes. Those having a static, conservative influence on economic activity are above all incomes drawn in accordance with a predetermined scale, namely salaries, wages reckoned per unit of working time, gains from exploitation of office powers, and normally all kinds of fixed interest and rents*

It is fascinating that these comments by Weber remind Guenther Roth (one of the best Weber scholars) of Pareto (See footnote 67, Weber, 1978, p. 211.) Pareto in *The Mind and Society* made an interesting distinction between “speculators” (those who seek profits) and “rentiers” (those who seek rent). A balanced market capitalist economy needs both speculators and rentiers; dynamism and innovation have to be counterbalanced by stability. Therefore, the proper question is not how much wages/profits vs. rent, but how much or what kinds of wages/profits vs. how much and what kind of rents. If there are too many speculators, it may damage the health of the economy, but the same goes for certain types and quantities of rentiers. Weber indeed seems to be deeply influenced by this idea of balance between speculators and rentiers, dynamism and stability, profits and rents.

Rent-seeking creates a different kind of inequality than profit maximization and calls for different policy responses. In our reading, Piketty’s most innovative contribution *Capital in the 21<sup>st</sup> Century* is his warning about the transformation of modern capitalism into the patriarchal system. In our reading, this implies that the growing proportion of high incomes and

<sup>1</sup> Or more modestly: in an economy thoroughly permeated with rents, there is no mechanism which guarantees the most efficient use of assets.

wealth from inheritance comes from rent based on monopolies or cartels, rather than profits or wages. This is consistent with the amendments Stiglitz (2015, I, II, III) and Atkinson (2015) made to the Piketty book. Capitalism in the late 20<sup>th</sup> and early 21<sup>st</sup> centuries has become unequal in a different way: more and more wealthy and privileged social positions are inherited.

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A trivially important area of inherited rent revenue comes from *real estate* and generally private wealth. The top 10-20% of society in the United States inherits substantial wealth, mainly in real estate, but also in pension funds and in other accumulated assets. The *educational system* is also an important terrain of closures, as defined by Weber. Given the high costs of education, especially of elite education, access to the most highly valued education may not be open to all, but it is close to youth whose parents cannot afford the often prohibitive costs. The reproduction of almost feudal privileges *via* education has become surprisingly strong in post-communist societies. The underprivileged strata of society have reduced access to tertiary education. In some countries, such as Hungary, there is a trend to go back to an early “tracking system” in the name of “labor market needs.” This system requires students to choose to pursue a vocational academic career as early as the age of 14. This stratification system entails putting young people from socioeconomically disadvantaged families on the vocational track, rather than the academic. In addition, access to study abroad is the privilege of a very small percentage of students born in newly enriched families only.

In the advanced Western democracies, there is an additional mechanism of closure in the educational system, called *credentialing*. Education is often conceptualized in terms of human capital investment. It is usually assumed that human capital invested in education will lead to productivity gains and higher incomes for the better educated. Powerful professional associations such as the American Medical Association or the American Bar Association, play a role in controlling the supply of occupations under their jurisdiction. Therefore, they may drive up incomes for specific occupations by adding rent to their income from normative requirements.

The emphasis on credentialing (rather than just on education or training) may have consequences on what kind of knowledge will be required from candidates seeking valued credentials. Not all knowledge required to pass critical exams will have productivity gains; it may be knowledge that is useful to screen candidates for such credentials. This is what Bourdieu (1970) called “cultural capital” as distinct from “human capital”. *Cultural capital* serves more the purposes of the reproduction of the “patrimonial middle class”, or “patrimonial upper class”, rather than increasing the productivity of the graduate. For parents, it may cost as much as \$300,000-\$400,000 for their children to obtain an Ivy League baccalaureate degree. However, an Ivy League degree will pass on to their descendants the status of “nobility”. Employers will seek an Ivy League graduate not necessarily due to their skills or qualifications, but because hiring such people will add to the prestige of their organization.

Acemoglu-Robinson (2015) and Atkinson (2015) highlight one of the controversial tendencies in Piketty’s work – that it tends to overemphasize the privileges and negative impact of

the top one % and neglects the inheritance of privileges (such as educational privileges as elaborated above) and wealth on the top 10-20% of society. In our opinion, the privileged position of the top 20% is just as problematic as the top one %.

First, inherited wealth, which is common in both the top 1% and the top 20% (and often exclusionary to underprivileged ethnic minorities such as African Americans)<sup>1</sup> is seen often as illegitimate by the rest of the society. Moreover, as we already explained above, there is no mechanism (unlike in the case of earning of profits) to allocate the inherited wealth in profitable way. Thomas Mann's "*The Buddenbrook House*" wonderfully illustrates how inherited wealth over the third generation disappears from the process of production, some used for charity, and some used for conspicuous consumption. Indeed, relatively few from the second or third generation of the top one % remain wealthy (Stanley – Danko, 1998).

Second, the top 0.1 or 1 % have a disproportionate influence on the political process through voluntary donations. Therefore, it is important to examine with scrutiny what happens to lifelong accumulated wealth and what sort of social objectives this wealth serves. Even in competitive liberal democracies, some individuals in the top 1 % virtually capture the state either by using their own wealth to secure office for themselves or by creating PACs to support candidates who are most likely to serve their interests.<sup>2</sup> Campaign finance reform is a burning issue in even the most liberal democracies. Nevertheless, in advanced market economies, many in the top 1 % use charitable donations not to capture the state, but to supplement the weak or hardly existing "double movement" (think of charitable contributions of Bill Gates or George Soros).

### *The Role of Rents in Post-Communist Societies*

As we argued in the preceding sections, there are some indications that Western capitalism may become patrimonial capitalism. In the post-communist context, we do not have the data yet to test Piketty's assertion. We can accept his general hypothesis, although it is still unclear whether the children of present-day oligarchs in Russia and China<sup>3</sup> will have the opportunity to pass their property rights to their children, including the right to sell these assets to foreigners or move the family's financial wealth to foreign countries.

Rent-seeking behavior was historically present in all capitalist market economies, even the most advanced. Early high levels of inequalities were driven by two forces:

- (i) in European countries (especially in England), the privileged estate was able to convert its feudal privileges into privileged positions on the market;

<sup>1</sup> See Oliver (1995) and Conley (1999) demonstrating that the major difference between whites and blacks is not in earned income, but inherited wealth.

<sup>2</sup> In the United States, a political action committee (PAC) is a type of organization that pools campaign contributions from members and donates those funds to campaign for or against candidates, ballot initiatives, or legislation.

<sup>3</sup> We may add to the list the post-Soviet Central Asian republics, Belorussia, Ukraine, Hungary – especially, but not exclusively after 2010, Romania, Bulgaria, Serbia, Albania, and Macedonia.

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- (ii) since appropriate mechanisms of market regulations were not in place, it was possible to create monopoly situations or to create cartel-like agreements. A fitting example is the “robber barons” of the late 19<sup>th</sup> century in the United States (Josephson, 1934, Folsom, 2010). Some of these robber barons came close to “state capture” until the state’s elite fought back with anti-trust legislation<sup>1</sup>.

The transition from socialism to capitalism was often driven or at least colored by similar and often more extreme rent-seeking behavior. During the transition from feudalism to capitalism, there was an intense struggle of old elites attempting to retain their power and convert their former privileged positions into economic wealth and power. Those who suddenly embraced the idea of free markets did not always realize that some regulation and planning might be needed even in genuinely free and competitive markets. Private property rights remain ambiguous. The conditions of law and order, the separation of powers, especially the separation of politics from the economy, were, and still are, in the process of negotiation. These conditions could not be implemented instantly after the disintegration of socialism. Even a quarter of a century after the transition, these conditions are still debated intensely in many countries. Post-communist capitalism is a curious system, where in many cases (Russia after 2000, Hungary after 2010, and Poland after 2015) *“politics remain in command”*. Ironically, Mao correctly defined the essence of socialism precisely with this formulation.

Institutional inertia of transitioning was aggravated by a sense of urgency to convert state property into private wealth as fast as possible (although this was not the case in China). In 1991, Boris Yeltsin set a goal to build capitalism in Russia in 500 days. During the early 1990s, political elites and their economic advisers believed that once identifiable owners are found for formerly state-owned firms, the free market will resolve all other problems. They did not care about the rights or identification of the original private owners. If the first owner is incompetent or corrupt, he will be replaced by market competition with competent market actors.

Given the specific circumstances, we shall distinguish three different rent-seeking mechanisms.

### ***First mechanism: Market Capture by Political Elites***

Market capture by political elites has multiple variants.

*Political capitalism: the use of market mechanisms by communist cadres to turn state property into private wealth*

In the early stages of privatization, it was often assumed that the former communist elite would convert their political capital into economic wealth.<sup>2</sup> Indeed, it was seen by many commentators that post-communist capitalism was simply a “Kleptocracy” in which the

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<sup>1</sup> Theodore Roosevelt’s anti-monopoly legislation during the early 1900s is a prime example of regulating rent-seeking.

<sup>2</sup> This was the nomenclature bourgeoisie hypothesis of Erzsébet Szalai (1989), Elemér Hankiss (1990), and Jadwiga Staniszak (1991).

political bosses stole the state assets. Undoubtedly, this occurred in large numbers in Russia<sup>1</sup>, Ukraine, in the Central Asian republics, and to a certain extent, in Bulgaria and Romania, where the elite circulation was minimal during the first few years. As Hankiss and Staniszkis articulate, communist elites began early in Hungary and Poland, trying to convert SOEs into private firms by using the technology called “spontaneous privatization.” However, in 1989-1990, this group lost political power.<sup>2</sup> As far as we can speculate, neither Hungary nor Poland succeeded the communist political leadership in accumulating substantial wealth before 1989. Nevertheless, there is a kernel of truth to the Hankiss’ and Staniszkis’ hypothesis. Some of the post-communist “new rich” in both countries began to accumulate capital before and during the transition, eventually becoming a starting point for future wealth.<sup>3</sup>

*Market capture by political elites during the privatization of state property for personal enrichment or the recruitment of clients*

When mass privatization became the official aim of governments, SOEs were passed into private hands either by vouchers<sup>4</sup> or offered for sale on competitive auctions.<sup>5</sup> Workers, ordinary citizens and inheritors did not know what to do with vouchers, so they sold them to risk-tolerant young investors under daily changing market conditions. However, as we know from Polanyi (1944/1957), the market did not materialize from thin air. Also in these cases, markets were created by states and/or by political elites. The management and creation of markets was inevitable for both domestic and foreign investors.

During communist times, private ownership was outlawed; therefore, the accumulation of private capital was very limited. To enable domestic investors to purchase state property, the available property had to be underpriced. Domestic investors without a reliable track record or credit rating needed government-guaranteed loans. This required the allowance

1 One good example is Victor Chernomyrdin. In the mid1990s, the CIA estimated his net worth at \$5 billion, but he claimed to have ownership in a few million. In 1978, he was already working at the Central Committee of the Communist Party and then back-and-forth between high government posts (deputy minister, later minister of gas industry) and major managerial positions (chairman of Gazprom). He was the Prime Minister of Russia between 1991-1998. He passed away in 2010 and took his secrets to his grave. See Szelenyi (2010).

2 For an excellent comparison of Central European post-communist capitalisms, see Bohle Dorothee and Bela Greskovits (2012). However, it is important to underscore that none of the Central Europeans included on the Forbes billionaires list are known to have been high-ranking communist party officials prior to 1989, see Szelenyi (2010).

3 In Poland, for instance, Jan Weichert and Mariusz Walter – major owners of post-communist media – were suspected of having started their business while working for the Polish security services, though they vehemently denied this accusation. In Hungary, Sándor Demján, one of the wealthiest Hungarian today, started his career as a manager of successful cooperative (i.e., semi-private) ventures in the 1980’s. László Kapolyi was a high official during communist times and was listed among the wealthiest Hungarians after 2000 (see Kolosi and Szelenyi, 2010). By the time of his death in 2014, however, Kapolyi had lost all of his wealth.

4 Vouchers were handed out either for compensation of property lost under communism, like in Hungary, the Baltic states, etc. or as a share of workers, or citizens in public wealth, a method used in Czechoslovakia, Russia, and many other countries.

5 Until 1995, Hungary pursued privatization through open tenders and IPOs, in which foreign investors competed with each other. See Eyal, Szelenyi and Townsley (1998), Mihályi (2001), King and Szelenyi (2005).

of preselection to make bids at auctions. Preselection inevitably relied on the possession of personal or political capital. In countries where communist elites survived (like China) or where the new elites monopolized political positions (like Russia, Bulgaria, or Romania), the former (or in China still active) communist cadres had specific advantages.

China is a special case, since the market transition in China took place under the rule of the Communist Party. According to the *Forbes* and *Hurun* lists of Chinese billionaires (see Szelenyi, 2010), during the first two decades of the reform, wealth accumulation was mainly or exclusively driven “from below”. By the year 2000, virtually all Chinese billionaires came from humble backgrounds, beginning their careers as rice farmers or bricklayers. Privatization of large SOEs started around 1997, and there is some evidence that during the past decade or so, some high communist party cadres and their family did become super-rich.<sup>1</sup> The manipulation of markets served either the personal economic interest of the surviving political elites, or the elite may use it as a mechanism to recruit and retain clients. All political elites need clients, but this is especially important if a regime, like most post-communist countries, even Russia, wants to retain at least the semblance of democracy and faces at least apparently competitive elections.

Recent Russian history has similar examples, with the wealthiest businessmen also hailing from relatively unimportant (though not humble) positions.<sup>2</sup> These figures were initiated into the new grand bourgeoisie, since they were expected to be talented and loyal in exchange for “managed auctions” as described above. In an interview, Valery Streletsy told Klebnikov: “*The key factor in the privatization process was the attitude of Tatyana Dyachenko [Yeltsin’s beloved daughter] to this or that banker/oligarch (....). She would go to the President and say: this man is good man and that man is bad man; this should be supported and that should not be supported. (...) Tatyana Dyachenko is the only person [to whom] the President listens.*” (Klebnikov, 2001, pp. 202-203. Boris Berezovsky and Roman Abramovich are prime examples of people who

1 There are contradictory assessments of the personal wealth of former Prime Minister Wen Jiabao and current President Xi Jinping. *The New York Times* reported that their family wealth may be in the range of \$1-2 billion. If there is wealth in the Xi family, most of it was made by the President’s daughter, Qi Qiaoqiao, and her husband Deng Jiagui. It is also rumored that many large nominally state-owned firms are led by CEOs who are “princelings”, the children of former “revolutionary heroes (President Xi is one example). Therefore, these firms are in reality, entirely privately owned. (Personal communication by Lu Peng.)

2 Vladimir Potanin – a high official who invented the debt-swap scheme – was among the few high government officials who, after 1991, was not hiding and is listed as a billionaire. Mikhail Khodorkovsky is another case. Klebnikov (2001) offers a crisp description of his trajectory: He had a classic career path of a Yeltsin-era business magnate. In 1987, as a top leader of Moscow’s Communist Youth League, Khodorkovsky established a trading cooperative financed with the communist party’s money. The following year, he established a bank. From 1990-1993, Khodorkovsky began working for the Russian government, serving first as economic adviser to the Russian Prime Minister and then as deputy minister of fuel and energy. By 1999, Khodorkovsky was listed as the 5<sup>th</sup> wealthiest person in Russia, with an estimated wealth of \$500 million.

acquired substantial wealth mainly due to their contemporary personal relationships, rather than previous political connections.<sup>1</sup>

However, these “grants” given to the new grand bourgeoisie appointed by the political boss, also anticipated some return to the boss. In exchange for Yeltsin’s contribution to his growth as a businessman in 1996, when a Communist Party candidate represented a real threat to Yeltsin’s reelection, Berezovsky not only supported the Yeltsin campaign, but managed to persuade six other oligarchs (the so-called Big Seven) who were the wealthiest of the wealthy at that time, to push for the President’s reelection. In addition to Berezovsky, the members of the Big Seven included Mikhail Fridman, Vladimir Vinogradov, Mikhail Khodorkovsky, Vladimir Gusinsky, Vladimir Potanin and Aleksander Smolensky. In 1996, only five years after the collapse of the USSR, the Big Seven claimed that they owned half of Russia.<sup>2</sup>

*Manipulating markets after privatization either to serve the enrichment of new political elites or to recruit new loyal propertied bourgeoisie*

The suspicion that political office holders may use their office for personal enrichment is still a serious consideration in this period. Bálint Magyar (2016), a trained sociologist and former minister in the Hungarian Socialist-Liberal coalition government during the 1990s and early 2000s, characterized the post-2010 right-wing Fidesz government as a “*Mafia state*”. In his model, Mr. Orbán, the Prime Minister acts as “godfather”.<sup>3</sup> Some scholars claim that government contracts and EU subsidized programs are allocated to loyal clients: family members or members of an “adopted family.”

Markets were influenced in many ways after the completion of privatization. Arguably, one of the most important mechanisms is the manipulation of public procurements that, by law, require an open competition. Some sectors are particularly suitable for such manipulations

1 Boris Berezovsky (1946-2013) was one of the first and the most prominent founding member of the club of newly emergent oligarchs. In 1983, he earned a Ph.D. in mathematics and became director of one of the laboratories of the Institute of Management at the Soviet Academy of Sciences. There is no definitive indication that Berezovsky was close to high-ranking Soviet party officials. He had good relationship with the young reformers, Yegor Gaidar, Anatoly Chubais and Valentin Yumashev. Yumashev was a journalist who eventually became Yeltsin’s chief of staff and the second husband of Tanya (or Tatyana) Yeltsin. However, during the early 1990s, Yumashev was only a ghostwriter for the President. He helped Yeltsin write his 1989 book and helped him with “Notes of a President” published in 1994. It was Yumashev, who introduced Berezovsky to Tatyana, who at that time was the wife of Dyachenko a commodity trader, who later became Berezovsky’s business partner in Sibneft. With his newly acquired contacts, Berezovsky managed to take major managerial positions and eventually ownership in the car manufacturing firm Avtovaz, and the national airline, Aeroflot. His economic empire also included the aluminum industry and TV Channel 1, the most commonly watched station.

Another of these young “talents” discovered by Tatyana was Roman Abramovich. He started out in the shadow economy. It is rumored that he started out his business activities during the late 1980s by selling plastic ducks out of his Moscow apartment and working as a street trader. In 1993, he met Berezovsky, who liked him and introduced him to the “family”. In 1995, in the loanforshares program the two men acquired Sibneft. Abramovich paid something like \$80 million for the whole company, which must have been worth several billion already at that time. Eventually, he even moved to live inside the Kremlin and became a close friend of Yeltsin’s daughter Tatyana Yeltsin, who often spent time at Abramovich’s dacha. So, this is indeed something like the “adopted family”, a term coined by Magyar (2016) explaining his theory of the “mafia state”.

2 The Big Seven – Russia’s Financial Empires, [www.worldbank.org/html/prddr/trans/feb98/bigseven.htm](http://www.worldbank.org/html/prddr/trans/feb98/bigseven.htm)

3 It is noteworthy that Klebnikov used this term already for Yeltsin in 2000.

(e.g. road constructions, IT services, commercial advertisements of SOEs). By governmental decree, such purchases can be declared to be “emergent”, to shortcut complicated competition and give contracts to clients (occasionally they may be even proxies to government officials). Without competitive bidders, or with a reduced number of bidders, the price for the services the government contracts can be way above what would have been in free competition; therefore those who win such bids collect substantial rent over the profit they would have made on real markets.<sup>1</sup> The government can also limit rewarding licenses, for instance, to the most popular radio stations or television channels.

As the Yeltsin example illustrated, electoral campaigns need funding from wealthy supporters, who finance the campaign directly and indirectly through the media. Such deals could have been the source of personal income for political bosses such as President Putin in Russia or Prime Minister Orbán in Hungary.<sup>2</sup> The allocation of tobacco shop licenses in Hungary was a trivial case to collect a large number of supporters. Prior to this, virtually all stores (including grocery stores and gas stations) were allowed to sell tobacco, and a substantial part of their income came from this trade. In 2013, the government created special tobacco stores, which acquired the exclusive right to sell tobacco, transferring “rent” from other stores to the newly licensed tobacco stores. This was not a major source of income; nevertheless, it created a 20-year monopoly for many small and medium-sized shop owners, who, according to opposition politicians, were loyal supporters of the government.

Of course, such manipulation of markets is well known in all countries (a famous example is the public purchase of military equipment in the United States). However, as discussed above, these practices are especially widespread in the post-communist economies. This is not only our opinion; it is one of the main reasons why these countries are labelled “corrupt” by Transparency International. Ironically, EU money to help the new (post-communist) member states did more harm in this respect than the progress emanating from the newly built transparency mechanism arising from EU membership.

### *Second Mechanism: State Capture by Oligarchs*

State capture by business elites is most often seen as cases of rent-seeking and corruption in non/post/communist emergent markets, for example, North America in the late 19<sup>th</sup> century, or Africa in the 20<sup>th</sup>-21<sup>st</sup> century. Such rent-seeking behavior exists in post-communist nations,

1 For an empirical study of the situation in Romania, see Pirvu (2015).

2 Vladimir Putin's personal wealth is the subject of wild speculations. Some commentators claim he is the wealthiest man in the world with a personal property \$40-\$70 billion. Putin's official disclosure acknowledges his property to be worth \$119,000 (he owns two apartments and one garage place). There are also similarly wild and unconfirmed speculations about the private wealth of Hungarian Prime Minister Viktor Orbán. Political opponents may overestimate the personal wealth of current political officeholders. In any case, smart political bosses do not accumulate wealth in their own name but rather pass it on to their extended family of friends. Therefore, if Putin indeed managed to accumulate wealth of his own, it may be under the name of his daughter Yekaterina and her husband (it is reported the couple owns \$2.83 billion in Silberg Company). Putin's friend, the cellist Sergei Roldugin is also believed to act as his surrogate, who has reportedly moved billions of dollars in Panama.

but it is relatively rare, given the weakness of the propertied bourgeoisie and its dependence on the political elite. Those who managed to capture the state in the United States in the late 19<sup>th</sup> century were called “robber barons”, prime examples including Rockefeller, Vanderbilt, and Gould. In the post-communist world powerful figures such as these are called oligarchs.

The notion of oligarch is disputed. In this paper, we call oligarchs those super-wealthy individuals who managed to privatize the State itself (to use again Klebnikov’s term). Therefore, individuals who did not become wealthy because of previously occupied political positions or loyalty to political bosses instead managed to use their wealth to capture the State itself. They were not unlike the “boyars” of early tsarist Russia, a class of wealthy individuals who used politics and the State to gain wealth rather than the other way around. It is only in Russia, by the end of the Yeltsin years, where we can see cases of such state capture by the new wealthy.

As the Russian state began to collapse, the largest business conglomerates began to build up their own armed security forces, occasionally with as many as 1,000 mercenaries. Indeed, large businessmen needed security forces, since the city of Moscow was ruled by mafia, usually run either by Russians or Chechens, and without protection from one or the other, life was virtually impossible for such business figures. Two such figures: Gusinsky (protected by Russians) and Berezovsky, (protected by Chechens) suspected each other as responsible for assassination attempts and framing plots with law enforcement. Finally, in 1996, the two giant oligarchs negotiated an agreement to cooperate, rather than destroy each other.

Berezovsky is the closest definition of an oligarch. After Yeltsin’s 1996 presidential reelection, Berezovsky became involved in state affairs, serving as Deputy Secretary of the National Security Council in charge of Chechnya. As many of his bodyguards were Chechens, he had working relations with the Islamist leaders responsible for the Chechen uprising. Even after Berezovsky left this position, he continued negotiations with Chechen rebels to free hostages. Berezovsky used his business success to gain substantial political power, even political office and many commentators – like Klebnikov – assumed he might have used this office to further his personal enrichment.

### *Third Mechanism: Capture of Oligarchs by Autocratic Rulers*

In 2000, Berezovsky and some of the surviving members of the Big Seven (namely Khodorkovsky and Fridman) supported President Putin’s election, bringing Putin “into the family” – to use the Mafia language. But Putin was no Yeltsin. He wanted to be Peter the Great and did not want to be bossed around by the “boyars” – i.e., the oligarchs. Although in 1999, Berezovsky was elected to the Duma (the Russian legislature), he soon clashed with Putin and fled to England. Later, he was accused of various murders and sentenced to prison *in absentia*.<sup>1</sup> Berezovsky became Public Enemy Number One for Putin’s Russia – it is rumored

<sup>1</sup> While no murder charges were proven against him in any fair court of justice, but he was suspected to be involved in the murder of Vlad Listyev, Russia’s most successful TV producer four years earlier. Listyev supported the privatization of TV 1 to Berezovsky, but he advocated a fair competition for advertising time, that clashed with Berezovsky’s interest.

that there were several attempts by Russian agents to murder him in London. He passed away in 2013 in unclear circumstances.<sup>1</sup>

Much like Berezovsky, Khodorkovsky was also far too politically ambitious for Putin. In early 2003, sensing trouble with the new political boss, he proposed to merge Yukos with the other major Russian oil company, Sibneft. As Berezovsky had to escape Russia, he passed ownership of Sibneft to Roman Abramovich (ranked No. 2 on lists of wealthiest Russians even in 2009), who regarded Berezovsky as his mentor. In 2003, Khodorkovsky was put on trial for corruption and sentenced to prison. He was released in 2013, after which he moved to Switzerland with a small part of his former wealth. In 1999, he was believed to own \$500 million; today, his assets are estimated to be around \$100 million. While Khodorkovsky was “eliminated” by Putin, Abramovich is a survivor. This may be due to the fact that, unlike Berezovsky or Khodorkovsky, he kept a low profile and assured Putin of his unconditional loyalty. As a reward, he inherited a great deal of property from his former mentor-turned-bitter enemy, Berezovsky.

Excessive rent-seeking threatens the legitimacy of the regimes and even private ownership. In response, political elites launch anti-corruption campaigns. However, it remains to be seen whether the anti-corruption drive is indeed aiming at reducing rent-seeking or if it is merely an instrument to remove political enemies or reallocate the wealth of oligarchs whose loyalty cannot be trusted. Khodorkovsky was jailed for charges in corruption charges, but it is hard not to see political motives behind the Putin-Khodorkovsky war. These corruption charges may be instruments in a selective criminalization of enemies. Many members of the economic and political post-communist elites are likely to have skeletons in their closets. Businessmen under post-communist conditions – given the ambiguities of legal regulations and private ownership – may be even more likely to offer their gratitude (or bribes) to politicians. In more established liberal democracies, the political elite may be more inclined to accept appreciations of their services (accept bribes). There are many candidates labelled as “corrupt”, the question is: who will be selected, in the end?

In 2012, when the Communist Party of China transferred power from President Hu to President Xi, authorities promised to catch “tigers and flies” in a newly launched anticorruption campaign. So far, they have caught quite a few flies and some tigers, but those tigers look too much like political enemies to those in the highest positions of political power. The first tiger to fall victim to anti-corruption was Bo Xilai. Bo was the first secretary of the Communist Party of Chongqing, the largest city in the world and an aspirant for a position in the Standing Committee of the Politburo. He was a Maoism-inspired left populist politician. He kept speculators out of the urban land market and used the profit to build public housing, schools and medical facilities (Huang (2011). Although people had to sing songs from the times of the Cultural Revolution, they received better services. Bo Xilai appeared too popular and

<sup>1</sup> Berezovsky might have been killed by Russian intelligence services, or, he may have lost so much his previous wealth (most to Abramovich) that rather than readjust his lifestyle to live more frugally, he committed suicide.

too dangerous for the Beijing establishment. Although he was not innocent, his selection as the first “tiger” may have had more to do with his candidacy for the Standing Committee of the Politburo, rather than his involvement in corruption. The case against Bo Xilai started with a trial against his wife Gu Kailai. Gu was accused and eventually sentenced to life in prison for the murder of an English business associate, Neil Heywood. She might have been the murderer, but Heywood’s body was cremated immediately after his death, limiting in-depth forensic analysis and criminal investigation. Nevertheless, in 2012, it took the court seven hours to find her guilty and sentence her to life imprisonment.<sup>1</sup> Eleven months after the trial of his wife, Bo was also in court on charges of corruption and abuse of office. He was found guilty of having received \$3.6 million in bribes from two local businessmen. He may very well have taken those bribes, but what is curious is why top party leaders, whose family fortunes count in the billions of dollars, are not also being investigated on the suspicious speed of their wealth accumulation.

Selective criminalization and “capturing” the *nouveau riche* are not exclusively Russian or Chinese phenomena. Some commentators suspect the anti-corruption drive under President Johannis in Romania may also be politically motivated, and there is little doubt that witch-hunting was also used widely in Hungary, especially after 2010. The new center-right government accused many former socialist and liberal politicians of corruption. After spending long periods of time in “pre-trial detention”, these politicians were found to be not guilty by the relatively independent courts. The Hungarian government made another interesting case in a move against the perceived disloyal “new rich”. Mr. Lajos Simicska, the former treasurer of the post- 2010 Hungarian ruling party (Fidesz), and a previous winner of many restricted competitions for government contracts, suddenly lost the goodwill of the Prime Minister. By the end of 2014, Simicska was excluded from public procurement tenders, and his media firms lost all of their government advertisements. Most recently, even his hunting plot, which he rented from a state-owned forest farm, was taken away from him. As the prime minister stated, “*The trees cannot grow into the skies*”. Unlike Khodorkovsky, Simicska is not in jail, but his business empire is in serious trouble.

### *Concluding Remarks on Policy Implications*

Klebnikov (2001) compared the Russian oligarchs to the American Robber Barons of the late 19<sup>th</sup> century. However, as Klebnikov argues, the Robber Barons produced goods and contributed to the economic growth of the United States by operating a large portion of the competitive market economy. Many scholars of post-communist economies tend towards hindsight bias, agreeing that the Russian oligarchs did not produce much and only deposited their rent incomes in Swiss banks, accumulating spectacular wealth in real estate, yachts, and art collections. In the early part of the 1990s, this was not yet clear. Åslund (1995) and others justified their activities by claiming that the brutal behavior of the oligarchs was needed to

<sup>1</sup> Without a body and murder weapon one would have expected a somewhat longer trial. She confessed, but for murder the usual sentence in China is capital punishment.

overcome the resistance of the old *nomenklatura*. As of today, it seems that President Putin captured the oligarchs – as we analyzed above – and reversed the positive market reforms of the 1990s.

The purpose of this paper is not to make a case *against* rent-seeking and *for* profit-seeking. Pareto's observation seems to be insightful: a modern market economy needs speculators and rentiers: foxes and lions. The complex ecosystem of market capitalism needs both animals. Too many foxes, too much speculation, and unrestrained markets can cause instability and may require what Polanyi in *The Great Transformation* called the “double movement.” This may require the transformation of some of the market-earned profits or wages into rent for those who cannot provide for themselves or the market. However, too many lions, too much rent-seeking, can suffocate competition. John Locke states: “*this is to think that Men are so foolish that they take care to avoid what Mischiefs may be done them by Polecats, or foxes, but are content, may think it Safety, to be devoured by lions.*” (Locke (1698) p. 328). Of course, here, Locke means “fellow citizen competitors” as foxes and the absolute monarch represents the lion, but we translate this into the language of Pareto to present our thesis: Foxes are fellow competitors, who may outsmart us, lions are rentiers who already outsmarted us, by (ab) using their political connections, they restrict competition to their advantage.

Our main inference is that the crucial question is not the extent of measured inequality (income or wealth). Countries with a Gini of around 0.20 or 0.40 can equally be economically dynamic and socially cohesive. Beyond the ethno-racial, religious, and gender-based pay gaps, the key question is the following. Are inequalities stemming from a mechanism that generates competition as freely as one can create between workers vs. workers, capitalists vs. capitalists? Or does it stem from rent-seeking, hence the exclusion of some players from the competition by the politically connected ones? We would not go as far as Sørensen and assume an antagonistic class division between rent collectors vs. those whose income stems from profit or wages. We share Ricardo's position, namely that it is sensible to tax rents more than profits and wages. The current tax rates on property/wealth are rather low in OECD countries, leaving ample room for future change.<sup>1</sup> This is especially true for some post-communist countries, like Hungary, where the inheritance tax, called “death tax” has recently been almost eliminated. Lower VAT and modest taxes on wages and profits, compensated by high tax rates on inheritance and capital gains, seem to serve both social justice and economic dynamism.

<sup>1</sup> In 2012, the combined revenue from all kinds of property and (net) wealth as a percentage of GDP was in the range of 0.3% (Estonia, Mexico) and 3.9% (UK). <https://stats.oecd.org/Index.aspx?DataSetCode=REV> accessed 9 July, 2015.

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## COMPARATIVE ANALYSES

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### 4. The six competing types of domination in the early 21st century: Towards a new Weberian taxonomy

#### *Introductory remarks<sup>1</sup>*

Huntington (1991) observed that after the 1974 Carnation Revolution in Portugal, the number of countries that used democratic procedures increased substantially. He called this the third wave of democratization.<sup>2</sup> The collapse of the Soviet Union (Fukuyama, 1989) accelerated this process, and there was hope that the changes in China would eventually lead to democratization as well (Jeffrey Sachs, 2005, pp.186-188). During the early 1990's there was reasonable hope for a liberal democratic world. It appeared that democracy (free elections) would go hand-in-hand with liberalization of the economy, human rights and *vice versa*. In this interpretation of history, mankind was marching on a one-way evolutionary street from *dictatorship* to *liberal democracy*. The world arrived at the end of history.

Huntington and Fukuyama spotted a real trend in world politics. Between 1970 and 2005, more and more countries used competitive elections, democratized, and adopted liberal institutions. This visible trend was mirrored in the data generated by the Freedom House, which has been using its own metrics since 1975. These metrics, the Global Freedom Scores, ranks countries into *free*, *partially free*, and *not free* groupings by applying various indicators of democratic rights and civil liberties (Schenkkan and Rapucci, 2019). In 1975, Freedom House categorized 41 countries (27 %) in the world as free, but by 2005 this number rose to 89 countries (46 %).

This was good news for Huntington and Fukuyama, but the bad news was that even after the third wave of democratization, 55 % of the countries were still not free. Furthermore, while the 46 % of free countries had some sort of free elections and reasonably liberal institutions, they may not have matched the ideal type of liberal democracy. Zakaria noted already in 1997 that some countries were *illiberal democracies*: they held elections, but checks and balances on the executives were reduced, and elections were manipulated.

Using the American diplomat Richard Holbrooke's line of thought on the eve of the 1996 elections in Bosnia, Zakaria's paper started with the following quotation and words of explanation: "Suppose the election was declared free and fair," Holbrooke wrote, "and those elected are racists, fascists, separatists, who are publicly opposed to [peace and reintegration].

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<sup>2</sup> The first wave dated to the late 18th and early 19th centuries, the second after WWII.

That is the dilemma.” Indeed, it is a poisonous dilemma, not just in the former Yugoslavia, but increasingly around the world, Zakaria commented. “ Democratically elected regimes, often ones that have been reelected or reaffirmed through referenda, are routinely ignoring constitutional limits on their power and depriving their citizens of basic rights and freedoms. From Peru to the Palestinian Authority, from Sierra Leone to Slovakia, from Pakistan to the Philippines, we see the rise of a disturbing phenomenon in international life – illiberal democracy.”

Furthermore between 2005 and 2020, even though the trend towards liberalism and democracy was reversed, the proportion of free countries declined (Larry Diamond 2015, 2019; Richard Estes, 2019). The proportion of free countries was reduced from 89 to 82 countries (from 46 % to 42 %). The drift from liberal democracy to illiberalism or even to *autocracy* or *dictatorship* (Csillag and Szelenyi, 2015) affected more people of the world since such a drift took place in populous and strategically important countries. A straightforward example was Russia, which after a brief flirt with liberalism in the 1990s, five years after Vladimir Putin’s rise to power in 2000, moved gradually towards *authoritarianism* or even to dictatorship. Another important example was China as it began to shift back to dictatorship or even *despotism* after the appointment Xi Jinping as General Secretary of the communist party and state president in 2012 and 2013, respectively. Another disturbing change towards illiberalism or even authoritarianism is India, with the electoral win of Prime Minister Narendra Modi in 2014, and most recently the illiberal turn in Brazil with the election of Jair Bolsonaro as president in 2018. Turkey, which is the second-largest European country by population size, has been in the process of democratic backsliding since about 2013, although this was the policy of Prime Minister and later President Recep Erdogan, who was in power already from 2003 and then appeared to be committed to modernization and democratization for ten years.

In addition, the United States considered for two centuries as the prime example of liberalism and after the Civil War and especially in the 20<sup>th</sup> century as a flawless liberal democracy, during the four years of the Trump administration turned out to be one of the most disturbing examples of the drift from liberal democracy or *democratic conservatism* to illiberalism (Skocpol and Tervo, 2021). Sure, on November 3, 2020, US citizens voted against Donald Trump’s illiberal policies. The strong liberal institutions (especially the judiciary) prevailed, but Trump did severe damage to American democracy. Donald Trump’s ongoing claim that “the elections were stolen” from him is still believed by tens of millions of Americans. The electoral defeat of Trump does not mean the end of Trumpism, and the seeds of mistrust in the election has become deeply rooted in the minds of too many Americans.

Most countries of the former Soviet Empire (especially in East-Central Europe) experimented with liberal democracy. Their drift away from liberalism and democracy during the early 21<sup>st</sup> century is particularly disturbing to the “third wave of democratization theorists”. Countries like Hungary and Poland still hold elections, but their leaders distance themselves increasingly from liberalism or even accept the term “illiberalism” (Orbán, 2014) to describe their home-grown socio-political system.

Nevertheless, we still believe that Huntington and Fukuyama were basically right. Since 1974 the world has moved towards more liberty, more liberalism, and more democracy. However, by the early 21<sup>st</sup> century, we learned that the pathway of modern history is still far from a one-way evolutionary street. What happens is certainly not the end of liberalism and/or democracy, but it is certainly their retreat. As of 2021, the 195 countries of the world indeed did not converge in a uniform system of liberal democracies. In unfree countries, especially in those which are despotic or dictatorial, many or most people tend to be “unhappy” (in recent social research, social wellbeing is often measured by “happiness” rather than per capita GDP: Joachim Weimann, Andreas Knabe and Ronnie Schöb, 2015)). However, as the 19<sup>th</sup> century Russian writer, Leo Tolstoy famously wrote, “happy families are all alike; every unhappy family is unhappy in its own way.” There is more than one way of running disagreeable political systems. An analysis or a political strategy based on a simple dichotomy (capitalism vs. socialism or democracy vs. dictatorship) are not helpful and will probably not work in practice. Therefore, we try to build a new taxonomy of undemocratic, illiberal political systems and a paradigm into which we can fit the different existing forms of liberal and conservative systems as well.

### *Our Weberian approach*

In this paper and in some of our earlier writings, we tried to adopt Max Weber’s “types of domination” to actually existing systems of domination in the early 21<sup>st</sup> century. Weber’s three types, *traditional*, *charismatic* and *legal-rational* were coined to cover all human history. His major insight was that history moved from types of domination when those subordinated to domination obeyed a *personal master* whose authority was assigned to them by age-long tradition or by the charisma attributed to the leader. In contrast to traditional and charismatic authority under legal-rational domination obedience is due to impersonal law. Rulers and ruled are expected to obey the same laws.

We operate with three basic Weberian-like hypotheses:

- (i) Every society has some form of domination to keep the system working. With the benefit of hindsight, we can confirm that Weber was right. The dream of Marxists about a domination-free society and the “withering away of the state”<sup>1</sup> was not more than utopia, emotionally attractive to left and liberal-leaning intellectuals. Force and coercion must exist in every system, if for no other reason but to keep the criminals under control.
- (ii) Each country is a mix of various types of domination, and in each type of domination, countries can have a different degree of economic, political rights and civil liberties. From a closer inspection every country exemplifies a hybrid regime<sup>2</sup> – not only the authoritarian ones, as it is often understood in the literature (Diamond, 2002). Even

<sup>1</sup> This term was coined by Friedrich Engels in two important writings, the *Anti-Dühring* (1878) and the *Origins of the Family, Private Property, and the State* (1884).

<sup>2</sup> At this point, Weber’s line of thinking goes parallel with Karl Polanyi, as we asserted in Szelenyi-Mihályi (2020a).

the most progressive liberal democracies are not perfect “textbook” democracies. The concept of liberal democracy has several dimensions with measurable indicators, and there is no country where all these indicators reach the maximum value.

(iii) There is no linear evolution from one type of domination to the next. Historical change is rather cyclical. Some liberal systems may become illiberal or autocratic, but at one point, the wheel can change directions and a country can return to liberalism. The movement from one regime to another is not determined with certainty. It greatly depends on social struggles and international, global processes.

The purpose of this paper is to adopt this logic to the actually existing types of domination in the early 21<sup>st</sup> century by separating six forms:

[1] *liberalism*, [2] *conservativism*, [3] *illiberalism*, [4] *autocracy*, [5] *dictatorship*, and [6] *despotism*.

The advantage of our taxonomy offered in this paper is that it can be conveniently reconciled with the Freedom House categories: [1] and [2] approximate the meaning of “free” systems, [3] is equivalent to “partially free”, at the same time [4] – [6] tend to be “not free” countries. Before we go into our detailed analysis of these six types of domination, it needs to be underscored that in many parts of Africa and Asia, accepted as sovereign countries by international law – the peoples have never reached the capability to function as a nation-state. In the absence of effective central power, the people living there are *de facto* governed by local, traditional rulers or, in worse cases, by warlords or armed gangs with a different degree of coercion and resistance to the powerholders residing in the capitals. In such countries, the citizens do not believe that their government is legitimate, and the central state itself often becomes illegitimate in the eyes of the international community, too. These countries may break up to competing tribal, religious, sectarian communities within the state with deadly, permanent wars against each other. For the analysis of these countries, the widely used labels *failed state* or *fragile state* are very appropriate.<sup>1</sup> Afghanistan, Yemen, Somalia, and South Sudan are good examples – and the most recent conflict between Israel and the Palestinian people come close. Some of these communities may be even quite democratic, even if they may be shifting towards illiberalism (like Israel under Benjamin Netanyahu); others are dictatorial or even despotic (like the Gaza Strip under Hamas).

One may miss from the above list *populism*, which is often used to label a particular type of domination in contemporary literature. We see populism as a rhetorical style rather than something with an intrinsic value content, whose aim is to gain (or maintain) popular support. How much populist rhetoric is used will vary in different types of domination, usually little in liberalism and virtually none in despotism, where the ruler obtains obedience by the systematic use of force and probably the most in the electoral form of autocracies.<sup>2</sup>

Similarly, countless analysts, politicians, and average voting citizens place the problem of *corruption* at the center of their discourse. We disagree. As we explained at greater length

1 For an early recognition of this problem, see Helman – Ratner (1992-93).

2 Madde and Kaltwasser (2017, p. 87) comes close to this interpretation. See also Daron Acemoglu and James A. Robinson (2012)

elsewhere<sup>1</sup>, we consider corruption as one form of rent-seeking. We take an “interpretative”, somewhat value-neutral position (we see some rents as economically-socially necessary, others destructive). There is nothing generally evil about rent. We know no economies without rent. Even in advanced societies, rent complements profits, often to create social stability. Medicaid, unemployment benefit, etc., recipients also collect “rent” (income they did not earn). Furthermore, a word of warning about the uses of the term “corruption” is warranted. Anti-corruption campaigns are *en vogue* all over the world, especially in authoritarian regimes. Vladimir Putin and Xi Jinping, Recep Erdogan, and Viktor Orbán (and many similar examples can be found in Latin America, Asia and Africa) are all “fighting corruption” (though by their opposition they themselves are suspected to be corrupt). At the systemic level, in our opinion, the critical question is when profit-seeking behavior is significantly overruled by the logic of the rent-seeking economy and corruption within it.

Liberals are primarily committed to individual liberty. Conservatives emphasize the importance of tradition. In the early 21<sup>st</sup> century, liberals and conservatives are both legal-rational systems in the Weberian sense of the term. Both accept checks and balances; leaders are not particularly strong, they tend to be elected through competitive, “real” elections – i.e., where elections really matter. Illiberals yearn for a strong executive, which can represent collective (usually defined as ethno-national) interests over the individual ones. Illiberalism has elements of legal-rational authority, but it typically needs strong, visionary leaders who legitimate themselves with reference either to national or religious tradition and/or with the leaders’ charisma. Nevertheless, given the value connotations attached in the early 21<sup>st</sup> century to the term “democracy”, illiberal rulers also need some popular confirmation of their power. So, they typically held elections – at least in formal sense. How free and fair those elections are held is, of course, debated. The critical test is what the incumbent leaders do if they lose an election. Do they accept the transfer of power to their liberal or conservative challengers? If they do not, they are on their way to authoritarianism or dictatorship. That was Donald Trump’s dilemma, but strong liberal US institutions prevented him from taking the authoritarian or dictatorial road.

*Autocratic rulers* need the respect of their subordinates (hence they have to have “authority”) but do not necessarily need their democratic approval to gain/retain office. Here we follow János Kornai’s definition of autocracy (Kornai, 2014), who claimed that a regime is autocratic when elections cannot remove it. In other words, such regimes may hold elections, but they are sufficiently manipulated, so they have no “stake”. There is no realistic chance for an autocrat to lose an election. Let us remind our readers that dictators can still be legitimate in the Weberian sense of the term, as long as they obtain obedience without systematic coercion. Often, they are seen as the lesser under the circumstances and have a loyal staff. *Despots* rule just by coercion, often using the military even against their own staff, if they find it necessary. They use only “*Macht*” and have no “*Herrschaft*”, hence for Weber they are “illegitimate” (or “non-legitimate” to be closer the Weber preferred terminology).

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<sup>1</sup> Mihályi – Szelenyi (2019) and Szelenyi – Mihályi (2020b).

Moreover, each “actually existing” system of domination may fit more than one type, and even in the reasonably “clean” types, there are usually “subsystems” which are examples of another type. Thus, for instance, even in liberal regimes the family, as a *sui generis* institution – or even the university as another type of institution – may have “traditional” or even autocratic characteristics.

Each type of domination has different scores of economic or political rights and civil liberties. As we measure them, we follow rather closely the Freedom House methodology, though the aim of our analysis is strikingly different. As we noted above, Freedom House nowadays ranks countries as free, partially free, and not free. We - following Weber – believe that each country is a mix of various types of domination. Hence each type of authority may vary what scores they earn in economic and political rights of civil liberties. Altogether, we distinguish nine dimensions of economic, political rights, and civil liberties.

*Economic rights:* (1) Free market competition, (2) Security of ownership and (3) Equal opportunities.

*Political rights:* (4) Competitive multi-party system, (5) Separation of powers and (6) Rule of law.

*Civil liberties:* (7) Freedom of expression and free press, (8) Freedom of association and (9) Freedom to choose one’s own identity.

In each of these dimensions, we give a score of 4 to each type of domination, which is the closest to the “pure type” of the economic, political right, and civil liberties. We give a score of 0 if in that dimension the system does not ensure even the minimum of economic and political rights or civil liberties.

There is no linear “evolution” from one type of domination to the next; historical change is somewhat cyclical. Some liberal systems may become illiberal or autocratic, but at one point, the wheel can change direction and return to liberalism. The movement from one regime to another is not overdetermined; it greatly depends on social struggles and international, global processes. A good example is the breakdown of the Soviet Union during the rule of Boris Yeltsin. Initially, the process looked like it was moving toward democratization under the influence of international processes. However, this vast empire has been moving in the opposite direction since 2005, five years later than Putin assumed *de facto* unlimited power in 2000. In other words, just like Erdogan in Turkey, it was the incumbent Russian president himself who orchestrated to backsliding from a democratic pathway to the illiberal one.

### *Types of domination, economic and political rights and civil liberties*

Scores 4 or 0 are relatively rare in actually existing types of domination in the early 21<sup>st</sup> century. While liberal and conservative types of regimes tend to have an elective affinity with democratic rights and civil liberties, some liberal or conservative types of domination may not score high on all dimensions. Illiberal regimes tend to have lower scores on civil liberties than on political rights. Autocracies score lower on both dimensions than illiberalism. Since they operate in a global capitalist economy, they usually have to offer stable property

rights and business contracts. Finally, the strong value attached to “democracy” even despotic regimes may pretend to value elections as a mechanism to select (to be more precise to legitimate) political leaders. Thus, our scores in a given cell of the Table often reflect a range of existing possibilities (e.g., 2, 1, 0), rather than a single number (e.g., 3). This is on purpose. In some despotic systems, for instance, in North Korea, there is absolutely no security of property rights, since ordinary citizens have no rights to hold any kind of valuable assets (score = 0). In contrast, in other types of despotic regimes like Myanmar, private property is guaranteed to a certain extent even under the present rule of a military junta (score = 2).

Nevertheless, the constitutional right to own property is not without constraints, even in the most liberal countries. Under the British legal system, the Monarch (currently Queen Elizabeth II), as head of state, owns the superior interest in all *land* in England, Wales, and Northern Ireland. In most cases, this is usually irrelevant, but it can become relevant if a freehold property becomes ownerless. In semi-independent Hong Kong, all *urban land* is currently owned by the People’s Republic of China. In many Central European post-communist countries, there are virtually no limitations on the property rights of *agricultural land*. However, in some (e.g., Hungary), the ownership is strictly limited to natural persons, and there is an upper size limit of 300 hectares/person. The US is one of only a few countries in the world that allow private individuals to own the *minerals* under their land, a policy that dates to the Founding Fathers as they sought to elevate private interests over those of the British Crown.<sup>1</sup> In countries, using the concepts of continental law, the ownership rights over the mines belong to the state, and private individuals or firms can exploit them only through concessionary arrangements.

### *Liberal and conservative systems*

Let us begin with a more detailed comparison of liberalism and conservatism. While liberalism and conservatism are often presented as the two opposite poles of types of domination in comparison with other types of domination in a way, they are two sisters/brothers.

Their common features are the respect of law, security of property rights, and a great deal of commitment to free-market competition. They both tend to rank reasonably high on competition of a multi-party system and the separation of powers, particularly in terms of the existence of an independent judiciary.

But even in these dimensions, there are significant differences. For instance, while we tend to associate liberalism with a free market economy, the actual relationship between the economic policy of liberalism and conservatism in the economy is far more complex. Let us compare the subsequent US administrations, dominated by Democrats or Republicans – i.e., the liberal administration and the conservative one. Since Roosevelt, liberal democrats tend to be strongly committed to equal opportunities, hence they are more in favor of progressive taxation (and especially high taxes on high-income earners) and secure affirmative

<sup>1</sup> More than 10 million American landowners receive royalties for the exploitation of oil, gas and other mineral resources under their property.

Table 1: The nine characteristics of six different types of regimes

Types of domination	SCORES OF ECONOMIC AND POLITICAL RIGHTS AND CIVIL LIBERTIES								
	Economic rights			Political rights			Civil liberties		
	Free market competition	Security of property rights	Equal opportunities	Competitive, multi-party system	Separation of powers	The rule of law	Freedom of expression	Freedom of association	Free choice of identity
Liberal democracy	4,3	4, 3	4	4,3,2	4,3	4	4,3	4	4
Conservativism	4,3	4	3,2	4,3,2	4,3	4	4,3	4,3	3
Illiberalism	3,2	3,2	2	3,2	3,2	3,2	3,2	3,2	2,1
Autocracy	3,2	3,2	2,1	2,1,0	2,1,0	3,2	2,1	2,1	1,0
Dictatorship	3,2	3,2	1,0	1,0	1,0	1,0	1,0	0	0
Despotism	2,1	2,1,0	1,0	0	0	0	0	0	0

Source: Authors' own categorization and quantification.

action for disadvantaged minorities. Roosevelt, Johnson, and Biden are all committed to a substantial role of the government in managing the economy. What is today often called neo-liberal economics (George Soros called it market fundamentalism) was the economic vision of a politician like Margaret Thatcher or Ronald Reagan (“the state is not the solution; the state is the problem”). In fact, Reagan represented what can be called the best of republican conservatism. While Adam Smith (references to him are the inspiration of the label of neo-liberalism) indeed was opposed to restrictions of global markets, he was not an advocate of the “free market solves it all” view. (He used the term the “invisible hand”- the free market as the solution - only once, and even then only in the context of international trade). In the US, UK, and Germany, typically conservatives were supportive of lower taxes, less regulated markets, and balanced budgets.

In post-communist countries, where the primary task was to reduce the role of the government and give more room to markets, it was less evident that what they pursued was a conservative rather than a liberal policy.

During the last five-ten years or so, more and more attention has been devoted to the growing importance of *ethnicity* in the otherwise “free and fair” elections. This is a complicating factor of trusting in multi-party systems, when people cast their votes according to their tribal-, cast-, religious- or national minority affiliations, and even more so, if certain political parties are entirely based on an ethnic group. If these factors are quantitatively important, the principle of “elections matter” is profoundly hurt, as the final result is to a very great extent pre-determined by these demographic proportions. As the 2016 and 2020 US elections also showed, this is a critical shortcoming of the democratic electoral system not only in Africa or India, but in the old democracies, like the United States of America or Israel. Under particular conditions, even minor “political” parties can become “kingmakers” in national politics.

The most apparent distinction between liberals and conservatives is in the treatment of civil liberties. Liberals score exceptionally high in terms of freedom of choice of identity. In the 21<sup>st</sup> century, in this respect, conservatives moved in substantial ways closer to liberals. The German CDU, for instance, accepted same-sex marriage; in the US, Republicans also moved carefully into this direction, though regarding abortion, they remained vehemently opposed to “choice”). Nevertheless, traditional sex roles remain a major division between liberals and conservatives.

In terms of political rights, the differences between liberalism and conservatism are rather small, but they exist, nevertheless. To use 20<sup>th</sup> century examples, Germany, under Willy Brandt the political system was pretty close to “liberalism”, so was Sweden when Olof Palme was prime minister. So was Israel, while Yitzhak Rabin was prime minister. In the US during the 20<sup>th</sup> century, the archliberals were Franklin Roosevelt and Lyndon Johnson. In fact, what we call “democratic liberalism” in the US is quite similar to the Swedish type of social democracy. Let’s not make too much of words: democrats in the US (even the Bernie Sanders type, who call themselves “democratic socialist) and social democrats in Sweden want to create capitalism with a human face rather than abolishing markets and private ownership.

For conservatism in the early 21<sup>st</sup> century, the best approximation is the CDU/CSU regime (especially Angela Merkel) in Germany. “Never Trump” Republicans are good examples of conservative republicans in the US. After WWII, Germany tended to be on the conservative side, with outstanding examples being Konrad Adenauer and Helmut Kohl. We already mentioned Margaret Thatcher in the UK and Ronald Reagan in the US as free marketer conservatives. So, in terms of political rights in American and West European politics both Democrats and Republicans may earn a score of 4.

While in common parlance liberalism means democracy, this seems to be far more complicated in the real world. We live in a world economy where businesses need the same rules everywhere. So as far as the legal system regulating economic transactions is concerned, stable laws and a reliable judiciary are necessary. Hence, in countries like Singapore, where there are no liberal social policies (e.g., little freedom of speech) or political rights are minimal (e.g., lack of a competitive electoral system), business conditions may be relatively liberal. On the other hand, there are obviously liberal regimes that are not democratic. Pinochet’s Chile was as undemocratic as it gets, but as “neo-liberal” as one can think of. A good 21<sup>st</sup>-century example is Hong Kong after the Chinese tracked down its already rather limited civil liberties and political rights.

The same goes for conservative regimes. No one can question the conservative commitments of the Gulf Monarchies. Saudi Arabia or the United Arab Emirates are as conservative as it gets, and they rank low both in civil liberties and political rights. Nevertheless, they run an internationally accepted legal system as far as business is concerned, even if they are absolute monarchies. So, there is no legislature; the source of law is the ruler (or, in principle, the Koran). Nevertheless, the Gulf Monarchies use liberal business laws, but they are dictatorships (like Saudi Arabia), others are autocracies (like the United Arab Emirates, or even “softer” versions, like Oman or Kuwait), but they undoubtedly legitimate themselves with reference to tradition. Hence, they are conservative in this sense.

Hence liberalism (and traditionalism) does not necessarily mean meaningful and complete separation of powers and genuinely competitive democracy. It simply implies that the rule of law in matters of the economy. So, we have liberal democracies, but we also have liberal authoritarianism or even dictatorships (and during the past 15 years, the latter were gaining ground).

## *Illiberalism and autocracy*

Illiberal democracy is a particularly disputed concept. Can illiberalism in any meaningful sense democratic? For Fareed Zakaria (1997), the prime examples of illiberal democracies were African countries, dressed as “democracies”, but he cast doubt on their commitments to democratic values and noticed tendencies towards illiberalism in post-communist Europe as well. His insights became more relevant a decade or so later.

While the illiberal project aims at maximizing the power of the executive branch, to a large extent, given the liberal/conservative hegemony in the advanced countries of the world (EU, USA, Canada), and the need for globalized capitalist firms, investors need a stable legal environment around the world. The first requires leaders in power confirmed by at least democratically looking election, and the second requires a reasonably stable legal system and free judiciary (at least as far as the business sector is concerned).

Illiberalism, in our terminology, means a system in which executive power is increased. This implies a reduction (though far from total elimination) of the separation of powers. Illiberal systems are typically multi-party systems that have a legislature (though dominated by the party holding the executive power). They also tend to have a judiciary with at least some degree of autonomy from the executive power (though usually, the first step in the direction of illiberalism is the political control of the constitutional court).

We primarily see as illiberal post-2010 Hungary under Viktor Orbán and Poland of Jarosław Kaczyński (they even call themselves this way, though they flirt – unpersuasively – with labels like “conservatives” or “Christian democrats”), but there are similar tendencies in Slovakia, the Czech Republic, Romania and Bulgaria (and especially in the countries on the Balkan, for instance in Serbia). As we have already mentioned, following Kornai, we call a regime autocratic when elections do not have a stake; those in power cannot be removed from their position of power by elections, only by revolution. A similar project was in the making in the US under Trump, when he stacked the Supreme Court with Trumpian judges, and especially when Trump began to claim the elections were “stolen” from him, and in particular when on January 6, 2021, he attempted to stop the legislature from affirming the electoral victory of Joe Biden. Can such illiberal systems be accepted as democracies? Not really. As soon as elections do not “matter” and the ruling power cannot be removed by election, they cease to be democratic. Irrespective of how manipulated electoral rules are, we will regard them as a “managed” or “manipulated” democratic system.

So far, illiberal democracy is an incomplete or even futile system. The best example is President Trump, who pushed as far as possible to the absolute power of the executive branch. However, solid liberal institutions of American liberal democracy stopped him from “stealing” the elections from Joe Biden, the winner of the 2020 November elections, and Biden became the president. Orbán – contrary to Kornai’s predictions lost some major elections, particularly in 2019 he lost Budapest. Similarly, Erdoğan lost Istanbul and some other major cities. Kaczyński rarely holds onto the parliamentary majority, and like Orbán, Erdoğan may even lose national votes. So, no matter how hard illiberal leaders work on electoral rules, they

are still vulnerable at elections. Illiberal democracy is a fragile system or may even move back to liberal or conservative democracy or shift towards autocracy or even dictatorship.

A prime example of an *autocratic regime* is Putin's Russia. While Putin also finds it essential to hold regular elections to legitimize his rule, there is no chance of removing him from power by elections. He does not allow candidates who could challenge him to run at elections – or even murders them – and by all likelihood, even the elections' results are falsified. Nevertheless, Putin – at least so far – has “authority”. Nationwide, some 70-80 % of Russians approve his way of governing (but this is not true in Moscow or in some other cities). If his approval dips further, he can find ways to wage wars and appeal to Russian nationalist sentiments, as it happened in Crimea and Eastern Ukraine, or he may have to establish a dictatorial regime.

Arguably, post-Maoist China became a kind of autocracy, too. While Deng Xiaoping and his successors did not need “real” elections, which looked “democratic”. In the countryside, they held a few competitive elections, but nationally, they held only communist style “quasi-elections” having only one candidate for votes. Given the economic success of their policies and their tolerance for relatively free expression of opinions, the present generation of Chinese communist leaders had enough “authority”, so they did not need to use excessive coercion to obtain obedience.<sup>1</sup> In post-Maoist China, some degree of “division of powers” was also established, at least within the communist party for many years. According to well-informed China watchers, after 1979 the Politburo's Standing Committee was composed of representatives of various political factions of the party. This does not seem to be the case anymore.

### ***Dictatorship and despotism***

A dictator is a political leader who possesses absolute power. A dictatorship is a state ruled by one dictator, by a small clique of ideologues, or by a military junta. Dictators' action radius is controlled and limited by their professional staff, or, using another Weberian category, the bureaucracy. By contrast, despots do not tolerate any external control or guidance. They have ruled without a professional staff for decades. Some of them sincerely believe in ancient superstitions. They are inclined to create an alternative reality for themselves because of their paranoid personality disorder. These characteristics largely explain the *unpredictability* of all despotic systems.

After the rise to absolute power by President Xi, China seems to have returned to the Maoist system of dictatorship (though it is still far away from the Cultural Revolution type of insane despotism and anarchy). Xi filled the Politburo's Standing Committee with his loyal followers, sent his opponents to jail (often accusing them of corruption or even murder), the primary example being the rather popular Bo Xilai, from Chongqing, a leading candidate to join the Standing Committee. No one since Mao has had so much personal power as Xi. He relies extensively on the secret services as it was always the case under Mao, but now he is also

<sup>1</sup> In our earlier writings – e.g., in Mihályi – Szelenyi (2020, 2021) – we argued extensively that China today is a communist system using some building blocks of market economies, rather than the other way round (a capitalist system with some remaining socialist characteristics).

using a highly sophisticated computerized surveillance system to crack down on any possible opposition to his authority.

Nevertheless, Xi's dictatorship, though based mainly on fear of the leader, is predictable. If you keep your mouth shut and remain loyal, there is no reason to be concerned. The "black limousines" will not come in the early morning for a loyal citizen. You know what you have to do, and if you do it you are safe. While a million Muslim may be in concentration camps, if they confess to being loyal Chinese communists, they have nothing to fear. This was also the real difference between Lenin's Russia and Stalin's purges during the 1930s or late 1940s. Under Stalin, faithful communists from high and low ranks were shot dead or sent to the Gulag for no rational reason at all.

Like Lenin, Stalin, or Mao, Xi has substantial authority and respect, too. His system is not based solely on coercion. Beyond the country's economic and international success, he also builds a well-tolerated, relatively modest *personality cult*. He is called in official press as "our father" and he wrote his own name into the Preamble of the Constitution, next to Marx, Engels, Mao Zedong and Deng Xiaoping. In 2018, he also changed the Constitution to declare himself as a lifelong president (Article 83). Putin did not manage to achieve this.

There are many despotic regimes in the early 21<sup>st</sup> century. The most notorious example is North Korea, where domination seems to be based primarily on coercion, which is exercised in a rather unpredictable manner – much like in the classic example of Stalinist communism – when loyalty to the ruler is no guarantee of being safe from coercion. There are similar systems of domination worldwide, some in Asia, Latin America, quite a few in Africa, and the most recent example in Myanmar. Myanmar was a despotic military dictatorship between 1962 and 2011 - for almost 50 years. After a heroic struggle by liberals, especially Aung San Suu Kyi, who even received the Nobel Peace Prize for her consistent stand for democracy in 2008, a compromise constitution was adopted, which gave 25 % of the seats in parliament to the military. Finally, in 2015, she won the elections. How liberal democratic the new regime was can be debated. When, later, the military led a genocidal attack against Muslims (Rohingya) in 2017, Aung San Suu Kyi, to the surprise of Western liberal democracies, defended the military. This compromise might not have been the wisest one. In February 2021, there was again a military coup, and a new despotic regime took rule, but intriguingly in the name of defense of "democracy". Much like the far-right elsewhere, like in the US under Trump, the military junta questioned the legitimacy of elections that they did not win. But the fight is far from over. As Ko Moe Yan Naing, a former police officer, now in hiding, told the *New York Times* (May 11, 2021): "Myanmar is going back to the old days, when people were scared that their neighbors would inform on them, and they could be arrested for no reason at all". Sure, but so far, people seem to be resisting; the return from a semi-democratic system to despotism may not be that simple.

## *Concluding remarks*

The last decade and a half have brought no good news for democracies, be they liberal or conservative. The pathways of domination are not one-way streets. Systems of domination tend to move in cyclical ways. Legal-rational domination, with its bureaucratic/democratic political institutions and their commitment to formal rationality, tends to work slowly, and they can be challenged by strong, charismatic leaders who promise to deliver miracles and deliver them instantly. This is exactly what happened in the past 15 years. Donald Trump won in 2016 by promising such a miracle to make America great again. Believing in miracles, it was white and protestant voters who drifted the United States towards illiberalism. In four years, few of the populist promises were fulfilled, given the powerful resistance of the 200-year-old American liberal institutions. Hence, Trump lost the 2020 elections by a considerable margin of popular votes. Nevertheless, Trump continued his attack against democracy with the Big Lie, claiming that the elections were stolen from him, and since many Republican voters (up to 70 %) still hope that the miracles would be delivered soon. The Republican Party is in disarray. Some Reagan-type republicans, like Liz Cheney or Mitt Romney, are outraged by the Big Lie and remain committed to democracy, but though they fight for the “soul” of the Republican Party, for true conservatism, they have to face rank-and-file Republican voters who still admire the charismatic leader and may vote for a “Trumpist” candidate in the next elections.

Similar changes took place in Russia, India, Brazil, Turkey, and, of course, in China. They are all ruled by strong, charismatic leaders, Putin, Modi, Bolsonaro, Erdoğan, Xi and they shifted to authoritarianism or dictatorship. But if the promised miracles are not forthcoming, all these leaders face loss of faith in their authority and charisma. As long as there are reasonably free and fair elections, they may face competition from liberal or conservative democrats. So, the political cycle may move back in the opposite direction. Leaders who begin to lose their charisma may be forced to use more coercion and more dictatorial policies.

Much to the disappointment of “third wave of democratization” theorists, a similar shift occurred in quite a few post-communist Eastern European countries, in a pronounced way in Hungary and Poland, confessed “illiberals”. The Hungarian regime, given the stronger charismatic appeal of Mr. Orbán, seems to be more stable than Kaczynski’s Poland, but even the Hungarian regime lost some critical elections in 2019 and faces serious competition in 2022. Thus, the big question: in the not very likely case that Orbán would lose the 2022 elections, would he concede or would he try the Trump-way out of such a loss?

The bottom line: In the early 21<sup>st</sup> century, the electorate occasionally is upset by the slow and often messy decision-making of democracy and the complexity of the rule of law in liberal and conservative democracies. But the alternative systems of domination, as described in this paper, depend to a large extent on the personalities of leaders (and their charisma). Hence, they are not particularly stable, may eventually move back to a more democratic policy, or they just may use more coercion to obtain obedience. This is not by chance. The purposeful construction of a personality cult around the unquestionable leaders of illiberal democracies, autocracies, dictatorships, and despotic regimes is a two-edged sword. It helps to keep the

executive power in the hands of the ruler, but inevitably a vacuum is created if and when this leader weakens, or disappears due to ill health, aging, a well-organized uprising, or sudden external shock. Then, the change can come quickly. As the British prime minister, Harold Wilson once famously said, “one week is a long time in politics”.

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## 5. Karl Polanyi: A Theorist of Mixed Economies

### *Introduction<sup>1</sup>*

It is not easy to locate Polanyi in the intellectual landscape of his times. All of his life, he was on the unorthodox Left (Dale, 2016), but exactly due to his resistance to all orthodoxies, he never found a real theoretical/political “home” for himself. Luban (2017) accurately writes about “the elusive Polanyi,” rejected by liberals *and* neo-liberals (is there a difference between the two?) for his criticism of “market fundamentalism” (Block and Sommers, 2016) *and* by revolutionary Marxists as a revisionist social democrat.

There are two conflicting readings of Polanyi’s works. Lacher (2019) distinguishes a “soft” and “hard” version of his theory. The soft version sees Polanyi as an early theorist of the “mixed economy”, where market failures are compensated by government intervention (Szelenyi, 1991, Block and Sommers, 2014, Sliglitz, 2001). Others see him as a radical socialist (Kari Polanyi-Lewitt 1994, Hann, 2019). It is notable that the hard reading of Polanyi typically comes from soft evidence: unpublished materials, like correspondence, lecture notes from his archive (Lacher, 2019), rather than the text he considered to be publishable in respectable academic outlets.

In section 1, we offer a contrast between these two interpretations while reminding the readers of his biography. Polanyi’s elusiveness arguably had a lot to do with his challenge to navigate between two individuals he dearly loved, his younger brother, an anti-communist, and his wife, who was for a big chunk of her life a “Marxist-Leninist revolutionary”. In Sections 2, 3 and 4, we revisit three themes of Karl Polanyi’s *oeuvre: The Great Transformation* (1944) and his contributions to *Trades and Markets in Early Empires* (1957).

In Section 2, we propose a somewhat unorthodox interpretation of his distinction between three forms of economic integration, enriching it with our own rather novel theory of *rent*. While the hard interpretation of Polanyi sees him as a complete rejection of the market economy (and a radical socialist critique of capitalism), our central point is that he mainly advocated a mixed economy in which, in modern economics - markets are likely to play the dominant role. In 1944, the fall of fascism was becoming clear, and the question was what would be the shape of the post-war societies. In our “soft” interpretation, Polanyi wanted capitalism to transcend what it was in the 1920s, but the book is consistent with Keynesianism, the New Deal, and the economic policies of post-war Scandinavian-type Social Democracy.

Then, in Section 3, we make a few comments on his views about globalization and the world market. In some ways, Polanyi laid the foundation for what came to be known as “world

<sup>1</sup> The original English language manuscript was first published in *Theory and Society*, 2021. Vol. 50., pp. 443-461. Electronic version published on-line on 15 August 2020. Re-published in hard copy as Chapter IV/4 in Ivan Szelenyi: *From State Socialism to Post-Communist Capitalism. Critical Perspectives*. Harrassowitz Verlag, 2023. Wiesbaden, pp. 287-307. ISBN: 978-3-447-11858-3.

system theory". Indeed, Polanyi saw world history as moving from redistributive empires to world markets. Polanyi and Wallerstein overlapped at Columbia. Wallerstein was, in his early work, an Africanist, and Africa was also a specialty of Polanyi. While Wallerstein, in the first volume of world system theory (1974), did not acknowledge the Polanyian origins of the theory, that was understandable. In the early 1970s, Polanyi was not *comme-il-faut*, since he was not a Marxist. The early version of world system theory was driven by Gunder Frank's 1968 radical revolutionary Marxism. The hard reading of Polanyi saw him as a world-systems theorist. In the soft reading, it is hard to see in Polanyi any signs of a "development of under development" theory, or a program to overthrow the system of "global capitalism", though this is exactly why Polanyi is so attractive to the early 21<sup>st</sup> century radical, revolutionary, anti-globalist left.

Finally, in Section 4, we try to use Polanyi to develop the political economy of "really existing socialism"<sup>1</sup>, knowing that Polanyi himself never offered a political economy of socialism. Here again the hard and soft readings of Polanyi clash. For the hard reading, reform communism of the János Kádár type is interpreted as "market socialism" consistent with Polanyi's vision of operating double movement, correcting the fault of pure markets (Hann, 2019). The first author of this paper, in his 1979 book with George Konrad, offered a radically different (and soft) reading of communist political economy. The Konrad-Szelenyi book used Polanyi's theory of redistribution to offer a radically critical theory of the socialist economy. The lesson learned from socialism was simple. Redistribution is not the solution; it is the problem.

### *The elusive Polanyi or the two Polanyis: the biographical background*

From his published scholarly work, it is indeed hard to tell who the "real" Polanyi was. Was he a radical whose aim was to overthrow the capitalist/market system, or was he the advocate of a mixed economy? What was its take on the USSR and Maoist China, or for that matter Kadar's "goulash communism"? There are no clear answers.

But from the extensive literature about his life, we know that during his adult life, he was caught in a crossfire between the people he loved the most, his younger brother (who early turned into a conservative and vehemently anti-communist philosopher) and his wife (a dedicated communist revolutionary for a great deal of her life).<sup>2</sup> Karl Polanyi was born in Vienna in 1886 in a well-to-do Jewish family (called at that time Polacsek, eventually he adopted the more Hungarian-sounding name of Polanyi). Karl grew up in Budapest. He was, of course, bilingual. He was "transnational", as well, often referred to as an Austrian-Hungarian social scientist and that is what he was, though you may add to this "English" and "American".

1 We use the terms socialism and communism interchangeably. In our view, in the communist ideology this distinction is merely an ideological construct. Well, some call themselves „democratic socialists" (like Bernie Sanders), but since they do not want to eliminate private ownership and accept markets as dominant coordinating mechanism, and just manage it, they are basically social democrats.

2 We have done no primary research on his life, so this section of our paper relies on information from the secondary literature. If new can claim any new contribution in this section of the paper is merely the claim that his "elusiveness" was deeply rooted in his personal struggles to build a bridge between conservative reformism and a radical revolutionary project.

His younger brother, Michael (who became at least as influential as Karl in physics and philosophy), was born in 1891 in Budapest.<sup>1</sup> Karl and Michael became involved in the so-called *Galileo Circle*, a left-leaning, liberal group of young intellectuals, flirting even with Marxism. The Polanyi family, like most Jewish families in the Austro-Hungarian Empire at that time, was rather secular, one may even say assimilated (their grandfather was a rabbi, but the Polanyi-children grew up without religion). Karl was a better fit with the Galileo Circle, Michael was seen by other members of the circle as an “independent thinker”, probably a bit too conservative (Nagy, 2018:83) and very early on he had an interest in the Christian religion. Karl also had his “religious turn”. He served during I. World War in the Austro-Hungarian army, but in 1917 he fell ill with typhus, read the New Testament while in hospital (Dale, 2016), but what captured his attention was the assumed affiliation between socialism and Christianity. So, one brother, Michael was led by Christianity towards conservatism/liberalism (are they different? what a mess of political science terminology ...), while the other, Karl tried to combine Christianity with socialism.

In 1918, they were both sympathetic to the democratic revolution led by Count Mihály Károlyi.<sup>2</sup> Michael, despite his fresh medical degree, became Secretary of Health in Károlyi’s government, but left it on the day the Hungarian Bolsheviks took over the power. Then he returned to medical practice. Later, he was the only person in the medical school who refused to join the Red Army. Karl gave the benefit of the doubt to the Hungarian communism (which took over the power from Károlyi in March 1919 in order to establish a Hungarian Soviet Republic). But he soon became disappointed. Already in May 1919, he left Budapest for Vienna. He claimed that this was for “health reasons” - a good excuse for political disappointment. Michael, an advocate of Károlyi’s republicanism, was strongly opposed to the communist takeover (and to the Leninist *coup d'état* of 1917 in Russia). Ironically, he did stay in Hungary until December 1919 when he found out that he was as much opposed to anti-communist, nationalist counter-revolution as he had opposed earlier the communist revolution. Karl and Michael remained loving brothers, but in collision in terms of their worldview for the rest of their lives.

There is another biographical detail we have to mention to appreciate the personal/intellectual tension in which Karl developed his intellectual/political identity. In 1920, Karl Polanyi fell in love with a young, married woman, Ilona Duczynska (1975). Soon she got divorced, then they were married and had a long and happy married life.<sup>3</sup> Ilona was also born in Vienna in 1897. Her father was a politically radical member of the Polish nobility. Her mother was an equally wealthy Hungarian noblewoman. Ilona commuted between Vienna and Budapest, studied engineering in Zürich, and was close to the anti-war circle of Lenin. She also joined the *Galileo Circle* but became a revolutionary communist. In May 1917, she was ready

1 He died in 1976, surviving his brother by 12 years.

2 Károlyi was a vehement opponent of the Great War. When the previous Prime Minister who took Hungary to the war, István Tisza was murdered on October 31, 1918, the King, Charles IV, appointed Karolyi as Prime Minister. Two weeks later, Hungary declared itself as “People’s Republic” (it meant a “liberal state”, but not a monarchy anymore), and Karolyi became President. On March 21 of 1919, he resigned and passed the power on to a communist regime, which transformed Hungary into a Soviet-type communist dictatorship.

3 She died in Canada, in 1978, surviving her husband by 14 years.

to murder the already-mentioned Hungarian Prime Minister, Count István Tisza, who was held responsible for Hungary's entry into the Great War. She even carried a gun with her to a public meeting of Tisza when the news came that Tisza was ousted by the king, so she abandoned her murder plan. Nevertheless, she was arrested and sentenced to two years in jail, but the October 1918 revolution liberated her.

She joined the Hungarian Communist Party in 1918. She represented the Hungarian communist government in 1919 in Zürich, and of course, after the fall of the communist regime, she had no choice but to move into emigration to Red Vienna in 1919. Given her independent way of thinking, she was expelled from the Hungarian Communist Party in 1920 for "revisionism". She was nevertheless attracted by the radical working-class movement in Vienna in the 1920s and early 1930s, joined briefly the Austrian Communist Party in 1934, but just again expelled at the order of Moscow given her increasing doubt of the show trials in the USSR. One odd consequence of post-WWII anti-communism in the US was that Ilona – a former communist party member – could not enter the US. Hence, the couple had to live at the Canadian side of the US-Canada border, and after Karl got jobs in the US (first at Bennington College, later at Columbia University) he had to commute to his US jobs from there. This US law was absurd: Ilona, who in Vienna earned a doctorate in physics at Vienna College of Technology in the 1930s, during WWII served in the British defense industry as a Fellow of the Royal Astronomical Society and was involved in developing the British air force. Nevertheless, the situation was that she did not qualify for a US visa since earlier in her life she was a member of a communist party.

This is the biographic background to Polanyi's "elusiveness". He lived in crossfire between his conservative, anti-communist brother and his wife, who, for a very long time was a "democratic Bolshevik", if that combination of terms was meaningful at all. The greatest challenge for Karl was to evaluate the USSR. He could not be critical enough to satisfy his anti-communist brother but could not be sufficiently appreciative of the Soviet experience to please his wife. This colored his views about markets and redistribution. The way out was supposed to be "Christian socialism" (at least early in his career), influential enough at the turn of the 19<sup>th</sup>-20<sup>th</sup> century, but disappearing after WWII, giving way to conservative *Christian Democracy*.

After the Great Depression, and especially after 1945, it became evident to many great thinkers of the time that *capitalism and classical liberalism could not continue to exist* the way they did (especially during the 1920s). John Maynard Keynes was, of course, one of the revolutionaries who came up with a vision for a future world order, but many others with (very) different political persuasions followed this line of analysis. Let's just mention the "conservative" Karl Mannheim (1940) and the "neo-liberal" Schumpeter (1943). Where does Karl Polanyi fit into this? In our soft reading, Polanyi was very close to the ways Keynes, Mannheim, and Schumpeter imagined the rebuilding of the world after the defeat of Fascism, but given her wife's radicalism, in his diary and in personal communications, his political views were a bit more radical. Indeed, Karl Polanyi tried to find excuses for the show trials of the 1930s. In 1956, after October 23, he was finally on the same side as his brother against the Russian invasion of Hungary. Interestingly, he was mainly enthusiastic about the "workers' council"

movement, which emerged late in the game, in December 1956. On the other hand, Polanyi had little to say when Imre Nagy, the communist Prime Minister who had liberal tendencies, was executed – the most horrendous crime committed by the Kádár regime.

In our soft reading of Polanyi, his explicit political avowals had almost no effect on his scholarly work. He remained an economic anthropologist, never turned into a political scientist. True, he made a few errors when it came to the political statements, but to regard him as a supporter of Kádárist reformism is untenable. Kádár turned from a blood-handed dictator into a communist reformer in 1963. Polanyi passed away in 1964 when “goulash communism” was hardly on the horizon.

The hard reading of Polanyi is mainly based on soft evidence, personal diaries from the Polanyi archive, and his correspondence. This archive is currently under the control of Polanyi’s daughter, Kari Polanyi Lewitt (b. 1923), a fine scholar who became close to classical world-system theory (sort of development of underdevelopment type). We respect her admiration for her father and the extraordinary work she put into sustaining the legacy of Polanyi. But she clearly has a scholarly (and political) agenda, which is missing the “elusiveness” of her father. We do not deny the attraction in Polanyi for a hard, revolutionary approach, but we would like to bring attention to his soft theory of mixed economies.

### *The three forms of economic integration: reciprocity, redistribution and market*

We have a long-standing interest in Karl Polanyi’s theory of various forms of economic integration (Konrad and Szelenyi, 1979, and Szelenyi, 1978). Our aim now is to offer (not an exegesis, but) a (not radically) novel interpretation of Polanyi. As an “economic anthropologist” Polanyi was critical of formal economic theories and offered instead a substantive view of the economy. Economies can be integrated in more than two ways: the dualist model of capitalism or non-capitalism is a misleading simplification.<sup>1</sup> When a society is composed by symmetrical groups, their economic integration is based on *reciprocity*. Ancient empires were held together by *redistributive mechanisms* (they are based on asymmetrical political and legal relations between rulers/masters and their subjects) just like modern economies operate through *market interactions* (based also on asymmetrical economic relationships between employers and employees – to put it with Weber - and owners of capital and owners of labor – to put it with Marx). Arguably, the most innovative contribution of *The Great Transformation* was the claim that none of these coordinating mechanisms (not even the market) is “natural”. They are all social constructions.

Usually, these three forms of integration are defined at various historical instances. To put this in the Marxist way, reciprocity sounds much like tribal society, redistribution like Feudalism (or slave society), and market integration is *the* “capitalist mode of production”. But Polanyi was more Weberian than Marxist. Yes, his concept can be used to describe macro-

<sup>1</sup> This was more fully developed in his *Trade and Markets in Early Empires* (1957).

structures, but they are also useful to characterize micro systems. And we have arrived now to our somewhat unorthodox interpretation of Polanyi.

In Table 1 and Table 2 we offer a historical comparison of a great number of economies with several combinations of Polanyi's three integrative mechanisms, but we interpret them as *three drivers of inequality* (which are particularly useful to conceptualize micro-level variations within a given system of integration). In our recent books (*Rent-seekers, Wages and Inequality*, Palgrave, 2019 and *Varieties of Post-communist Capitalism*, Brill, 2020), we explore various sources of inequalities - both wealth and income. Inequalities can be created by wages/profits, by rents and by gifts. In these tables, our dependent variable is income inequality. Wealth inequality diverges from this somewhat. But our tables are already complex enough, so we reserve some of our comments about the distribution of wealth for our narrative after Table 2.

In liberal market economies, wages (income and wealth from work) and profits (income and wealth from capital) are typical drivers of inequality. But what about rent? Is it the major driver of inequality in redistributive economies? Are there rents in market economies, and do they reduce market-induced inequalities? Is it the source of inequality in redistributive empires (or even in patrimonial systems)? And what about *gifts*? Is that unique for reciprocity, or can gift be the source of inequality in redistributive and market economies?

Adam Smith ([1776] 2006), the classical – in a way “ultimate” - theorist of modern capitalism believed that there are three sources of the wealth of nations, wages, profits and rents<sup>1</sup>. Marx disagreed with Smith. He saw labor as the only source of wealth, but for Marx both profit and rent were merely value appropriated from labor. Rent was just another form of profit.

In our work on rent, our inspiration comes primarily from Ricardo ([1817] 1911) and from the more recent literature from Aage Sørensen (2000). Ricardo disagreed with Smith and interestingly Marx did not appreciate his interesting insights. His argument was cast in terms of rent on land. Ricardo's major point was that the quantity of land available to produce agricultural goods is limited, while the demand for food is increasing, given the increases in the population. An owner of land does not have to produce more or better-quality food to have a higher income. Nevertheless, the question of whether the income generated by those who have monopolistic/oligopolistic ownership of productive assets may earn a higher income than those who compete on free markets remains relevant. He claimed that rent is not the source; it is only an indication of wealth. This proved to be false, since the productivity of agrarian land was growing at least as fast as the world's population. Agrarian production grew fast, actually faster than the population. There is still hunger in the world today, but not because we cannot produce more food, but due to unequal distribution of incomes and the incompetence of state redistribution.

<sup>1</sup> Smith sensed that there may be a difference how much contribution each of the members of the holy trinity gives to the wealth of nation: „As soon as the land of any country has become private property, the landlords, like all other men, love to reap where they never sowed and demand rent for its natural produce” (Smith, p.56). This may be interpreted as a hint that landlords collect rent without adding to the wealth (hence they obtain “unearned” income), while Smith believed that those who collect wages or profits all earn (and therefore morally deserve) their income.

Table 1: The main sources of income inequality in history, from tribal to feudalism to slave society and to classical capitalism

1. TRIBAL SOCIETIES		
Markets	Redistribution	Reciprocity
(3) Tertiary	(2) Secondary	(1) Dominant
In tribal, circular trade (Trobriand Islanders), boat owners may collect rents, and sailors may collect wages.	If a tribe is larger than extended kinship, the chief is likely to collect rents disguised as gifts.	In smaller, symmetrical, kinship-based societies, some trade is possible. The chief may have to allow some market exchange between slaves and non-slaves and he may collect rent.
2. CLASSICAL SLAVE SOCIETIES (EGYPT, GREECE AND ROME)		
Markets	Redistribution	Reciprocity
(2) Secondary	(1) Dominant	(3) Tertiary
Non-slave, free citizens (even some slaves) operate profit-oriented businesses.	Slave owners appropriate the entire output of slaves but may have to allow some trade among slaves (and even earning non-slaves to make the economy moving.	Though kinship is broken, the network of slaves can offer mutual help.
3. PATRIMONIALISM (WEST-EUROPEAN FEUDALISM)		
Markets	Redistribution	Reciprocity
(3) Tertiary	(1) Dominant	(2) Secondary
Urban citizens may employ wage labor and generate profit***.	Landlords collect rent from serfs in exchange for protection and agricultural land use but allow some market among serfs and non-serfs.	Serfs are allowed to have their own households and produce means for their survival****.
4. LIBERAL, MARKET CAPITALISM (ALL STAGES AND FORMS)		
Markets	Redistribution	Reciprocity
(2) → (1) From secondary to primary	(1) – (2) From primary to secondary	(3) Tertiary
In colonial times, within the core nations, some wealth is generated by profit-oriented businesses.  In the globalization period, profit-seeking is the main source of income and wealth.	In colonial times, the incomes of large private businesses often came from colonies as rents.  In the globalization period, the rent-seeking capacity of core countries is reduced. Oligopolies and monopolies also collect rent, which can be restricted by anti-monopoly laws.	Important for families (child-rearing), but in advanced and modern capitalist countries, some or most of mutual help tends to be institutionalized and commodified.

Notes:

\* See Malinowski (1922). While in *kula* trade, each transaction exchange is based on gift (reciprocity) and therefore economically meaningless or even irrational, after the whole cycle is completed, it turns out to be economically rational. The first island receives goods they need, though during their journey, it looks like all action is 'irrational' or ruled by 'tradition'.

\*\* Anderson (1985).

\*\*\* Max Weber (1978) makes this point in the chapter on The City in *Economy and Society* (Volume II, Chapter XVI) where he sees the increasingly market-oriented feudal cities a „non-legitimate authority”.

\*\*\*\* Anderson (1985) sees this as a critical distinction between slavery and Western feudalism.

Nevertheless, during the last fifty or so years, the question of *rent-seeking* has been increasingly applied to other productive assets than agricultural land. The most obvious example is real estate, especially real estate in central cities. The price and value of real estate in desirable urban locations grew much faster than inflation and incomes; hence, those who inherit or just sit on such real estate long enough see their wealth skyrocket without work or further investment.

Aage Sørensen (2000) expanded the notion of rent radically. He defined rent as income, which is earned above what one would earn in competitive markets. Therefore, if one leases a house to a tenant at a price, that covers the investments and improvements (plus market-defined interest), the owner collects a “profit” even if in common language it may be called “rent”. The same applies to pensions: the income of a retired person is derived from lifetime savings (and interests) is often called “rent”, though it is merely post-retirement “postponed wages plus profits”. In the way Sørensen uses it, rent comes from either the market (monopolies, oligopolies, cartels) or state-induced restrictions of the markets (in Sørensen’s logic, welfare payments, excessive income). Stiglitz (2013) comes close to this view. He states: “...there are two ways to become wealthy: to create wealth or to take wealth away from others... [S]ome genuine wealth creators often are satisfied with the wealth that their innovation or entrepreneurship has reaped. Some eventually turn to abusive practices like monopoly pricing or other form of rent extraction “He calls this “wealth transfer instead of wealth creation” (p.40)

This citation is important for our analysis. It confirms that rent-seeking can be deeply rooted in market integration, though the key argument in this paper will be that the major source of income/wealth inequality is a characteristic of redistribution and state limitation of competition. Well, not that Stiglitz disagrees. He sees government restriction of markets also another source of rent-seeking: “Rent-seeking takes *many forms*, [our emphasis<sup>1</sup>] hidden and open transfers and subsidies from the government ...This is often a negative sum game, which is one of the reasons, why on average, economies have grown more slowly...” (pp. 48-49). Stiglitz calls this “regulatory capture” (following Stigler, 1971, see Stiglitz, 2013, p.59). And he continues: “Another form of rent-seeking is... selling to government products at above market prices “(p.50). When regulatory capture (we called it “state capture of markets” in Mihályi and Szelenyi, 2020) becomes dominant, we face a marginal case between markets and redistribution, some call it “crony capitalism” (Minxin, Pei, 2016 and Anders Åslund, 219) or “mafia state” (Balint Magyar, 2016), which to put with Polanyi is between market and redistributive integration. But in any case, we make an attempt to integrate our rent-based approach to inequality in the model of all societies in history by distinguishing between the sources of income on the one hand, and wealth on the other.

We assert that all economies in the past and the present tend to be mixed systems (Szelenyi, 1991, Stiglitz, 2001). But it is possible and reasonable that we categorize an economic system

<sup>1</sup> This is critical for this paper. While the major source of inequality under redistribution is rent, some rents are generated by the very market integration. For instance, over-accumulation can yield to rent or “extra profit” not as a result of political/state/government intervention (that would be redistribution), but due to the lack of state action to protect free competition.

by identifying which of the coordinating mechanisms is dominant, which is secondary, which is tertiary. This is the approach we used already in Table 1. If market integration is dominant, we tend to call that system capitalism. Polanyi calls economies dominated by redistribution as “ancient empires” (by extension, we will try to apply its logic to patrimonial or West European feudalism as well). Societies organized by extended kinship ties, or “tribal societies” are predominantly based on reciprocity.

Nevertheless, dominant economic mechanisms cyclically produce failures; in cases of failures a secondary or tertiary mechanism kicks in to counteract the failures of the dominant mechanism. Polanyi, in his studies of market economy (capitalism) writes about countervailing tendencies. He calls this “double movements”. If uncontrolled or not sufficiently controlled, markets produce excessive inequalities of income and wealth, which may threaten social stability. Under popular pressure, the government may intervene with welfare measures, hence with redistribution. The government may impose high taxes on high incomes or even wealth and redistribute it to low-income groups who cannot earn enough income on the market to make ends meet. Some families, especially the poorest of the poor – think of poor Roma families in Eastern Europe – may fall out of the reach of the welfare state, so they have to rely on reciprocity, short-term, or often long-term help by kinship groups. But reciprocity may be present in affluent strata as well, and intriguingly can be the source of transfer of privileges to the next generation. If I give support to my granddaughter to finish college, it is merely a gift and it usually does not involve any market consideration. I do not consider by making such a gift, any future possible return on my “investment”. Such a gift can become especially important if, for welfare considerations, a government imposes too high inheritance taxes. In this case reciprocity is counteracting excessive redistributive intervention in the allocation of wealth.<sup>1</sup>

In small-scale societies, if one kinship group may turn out to be too small and they may not be able to produce everything they need, they may engage with a more extended kinship network in market like trade. Take, as an example, the Trobriand Islands (Malinowski, 1922). On each of the small islands, small tribes existed in economies dominantly integrated by reciprocity. But none of these small islands could produce a sufficient diversity of produce necessary for survival. Hence Trobriand islanders were engaged in extensive “trade”, what Malinowski called “*kula trade*”. Well, this “trade” was not quite market, since the islanders on their sailing trips exchanged the “gifts” (Mauss, 1954)<sup>2</sup>. On no island they visited, they receive the equivalents of what they gave. It was set by tradition what they had to give and accept. Nevertheless, at the end of their journey, they returned home with goods, which were equal to what they took on their trip, hence the whole *kula* cycle was like a market. In this case, failures of reciprocity were corrected by trade. In large, extended kinship groups, tribal societies, occasionally a Chief (who may have been seen as having magical powers, special

1 It is „excessive” to the extent it is seen as „unfair” by the wealthy.

2 According to Mauss (1925) gifts can be traded, but they are not commodities. Commodities have to be exchanged as change of equivalent values, gifts are regulated by tradition and when given or received their value is not evaluated. To put it with Polanyi, trade of gifts is “non-market trade”.

access to gods or spirits) emerges and members of the group may have to give tributes to the Chief without expecting reciprocity. One may consider calling such a tribute “rent” in the definition we will provide below.

In ancient empires, the ruler tried to extract as much produce from the local communities (or slave owners from their slaves, or landlords from the serfs) as possible (you may call it taxes, we will call them rents and will explain shortly why). If such a “tax-collection” or “rent-seeking” is too excessive and threatens the well-being of people, they either compensate for this by establishing local markets or rely on gifts from more fortunate kin by invoking “tradition”, based on the principles of reciprocity. The best-described examples were the Hydraulic empires, like ancient China (Wittfogel, 1957). Legitimized by flood control and irrigation needs the emperor appropriated a great deal of products from the village communities; nevertheless, these communes survived, given extensive reciprocity in the communes and in addition, a highly developed system of market towns.

This critical change of transformation from an antique slave society to medieval feudalism occurred when slaves turned into servants (Perry Anderson, 1985). As Anderson, with his rather unorthodox Marxism, points out, the fall of the Roman Empire cannot be explained by class struggles within the empire; it rather came from invasion by Germanic tribes, which brought into the system a novel system of property relations. Slaves were replaced by serfs, who, in exchange for labor on the feudal estate, had their own family estates (and families), hence, the great empires were replaced by economies where family organization played a crucial role. Landlords still took rent from serfs (forced labor on their estate), but in exchange, they allowed families to produce their own food and even permitted their surplus products to be sold on self-regulating markets.

Economies where the market is the dominant coordinating mechanism we call “capitalist”. Most market-coordinated economies are “mixed ones”; in our reading, they were the major objects of Polanyi’s analysis. Pure markets would be dysfunctional; they have to be complemented by welfare redistribution and some degree of reciprocity.

In Section 4 of this paper, we shall return to this theme, and we also raise the question of communist economies. Were they modern (or “rational”, rather than “traditional”) versions of redistribution<sup>1</sup> and if so, what was the role of the market on the one hand and reciprocity on the other, to limit the social and economic damage caused by “redistributive failures”? To the extent that redistribution can correct market failures, markets (or reciprocity) may correct redistributive failures.

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<sup>1</sup> Konrad and Szelenyi (1979) were often criticized for calling the communist economy „rational redistribution”, while its opponents emphasized the irrationality of the communist system. Our intention in this book was to underline the differences in the legitimacy claims of ancient and communist redistributive systems. Ancient systems were legitimated by tradition; the legitimacy claim of communism was „scientific communism”.

## *Globalization and the world market: the tendency towards dis-embedding. Polanyi's basically pro-market critique of market fundamentalism*

Modern capitalism was identified with the emergence of the world market at least since Adam Smith ([1776], 1976). For Smith, global capitalism was a win-win situation. As long as there is free trade, all parties will pursue the most efficient activity for them (*op. cit.* p. 401). He was a fervent critic of mercantilism, which aimed to maximize national wealth by imposing export-import duties. Instead, Smith advocated free international trade (hence his famous recommendation of the “invisible hand”).

Marx, in many ways, followed Adam Smith's line of analysis. Capitalism was a global system, but for Marx, it was a system of exploitation of the working classes wherever they lived and worked (it was win-win only for the bourgeoisie). Capitalism has to be overthrown globally: “Workers of the world unite!”. The question of core-periphery, imperialism and colonialism was not central for Marx's analysis. Marx considered the global variation of modes of production (social formations) in the *Grundrisse* ([1857-58], 1973, pp. 471-514). Anti-globalization and world system Marxists have little inspiration from Marx. They mostly refer to Chapter 14 of Volume III of *The Capital*, where Marx offered an analysis of the export of capital, or to Engels' 1892 preface to his splendid *Condition of Working Class in England*<sup>1</sup>, where he wrote about the “industrial monopoly” of England over the world, paving the way to the theory of uneven development and eventually imperialism.

With Rosa Luxemburg and Lenin, the theory of capitalism was substantially changed. Interestingly, both theorists came from the semi-periphery or periphery of the world system, from Poland and Russia, respectively, hence their understanding of the problems of capitalism was much less West-European centrist than the theory of Marx or even Engels. Rosa Luxemburg's 1913 book on *The Accumulation of Capital*, with her emphasis on “uneven and combined development” foreshadowed later Marxist works on “dependent development” (Evans, 1979) or “development of underdevelopment” (Frank, 1966) and Immanuel Wallerstein's world-system theory (1974).<sup>2</sup> The real breakthrough was, of course, Lenin's book on imperialism (1917), which in turn laid the foundation of a theory (or practice) dislocating the attention from the most developed capitalist countries to countries of the periphery. From here, it was just a small step to Stalin's interesting innovation of “socialism in one country”.<sup>3</sup>

1 This is the preface to the second German edition of the book ([1845/92] 1969, pp. 19-29).

2 Frank generalized out of the South American experience of the 1950s and 60s and argued that in the „third world” development means only deepening the „underdevelopment”. This was, of course, later contradicted by successful development stories especially in East Asia (like South Korea, Singapore or Taiwan) and eventually even in some South American countries (e.g. Brazil or Mexico), where Evans' theory is a better fit. Frank was an important inspiration for the early work of Wallerstein. But his ideas lead to an absurd conclusion: the only way out is a “counter-systemic” jump. Hence countries, which isolated themselves from the world market, like Albania or North Korea, adopted the only viable way to break the logic of the “capitalist world system”.

3 Stalin used this term for the first time in December 1924, see Carr (1958), Chapter 12.

Polanyi, in our reading, kept an equal distance from Smith and the Marxist theory. Like Smith and the Marxists, he dated the emergence of capitalism with the making of the world market. But he did not share Smith's optimism about the "invisible hand" of the market. Polanyi was a radical critique of market fundamentalism. Markets tend to become unregulated, but as this happens – as Stiglitz pointed out in his introduction to *The Great Transformation* -, markets can become self-destructive. This was not all that different from Schumpeter's intriguing argument that capitalism will not survive since it is too successful.

This is why "double movement", or "counteracting tendencies", are so central to Polanyi's thinking. Markets have to be disciplined; they have to be "re-embedded" (more about embeddedness later). Pure markets would cause unmitigated social – and even economic – disasters. But Polanyi was careful not to spell out exactly what combination of the three integrative mechanisms would really "work". There is no clear blueprint of the society – to use now Mannheim's (1940) terminology - "in the age of reconstruction".

But Polanyi was at least as far removed from the dependency theory and the development of underdevelopment view of the world as he was from market fundamentalism. The transition from ancient redistributive empires to a global market economy is central for Polanyi's view of history.<sup>1</sup> As this is happening, there is a tendency for "dis-embedding" – i.e. the separation of spheres. Polanyi, much like Weber, was not an "evolutionist". Markets replacing redistribution, moving away from deeply embedded economies towards dis-embeddedness is just the way the world is changing. Granovetter (1985), in his wonderful work on "embedded" economy did not acknowledge the historical trend toward dis-embedding, though already in the "strength of the weak ties" paper (1973), he saw that in a market economy, too much embeddedness can – and is likely to - have damaging consequences. E.g. on the job market in recruiting personnel, one cannot rely on "strong ties": you cannot hire the nephew of the boss. But given information shortages about job applicants, you cannot proceed fully bureaucratically either. You need letters of recommendation from earlier employers or teachers whom you trust, but who were not too close to the candidate.

We may use the terminology Weber scholars use to describe Weber's historical philosophy: Polanyi was not an "evolutionist"; he was a "developmentalist". What is dis-embedding in Polanyi is rationalization in Weber. Weber saw rationalization as inevitable but acknowledged its downside (the iron cage of bureaucracy). Around 1914, he began to use a new term, „dis-enchantment" (*Entzauberung*) to capture especially clearly what was lost with rationalization (while being fully aware what is being gained from it, see Szelenyi 2015). In our soft reading of Polanyi, he believed that when dis-embedding became excessive, the economy had to be re-embedded to avoid the economic and socio-political catastrophes, like the Great Depression.

<sup>1</sup> The idea that the capitalist world system replaces „empires" was critical for Wallerstein as well. Wallerstein and Polanyi were colleagues at Columbia (and both were experts on Africa). Hence it is not unjustified to see Polanyi as a predecessor of world system theory. But when in the early 1970s, Marxism became a major new force, making references to Polanyi, who was mostly seen – in the soft interpretation - as a welfare-statist, social-democratic liberal was inappropriate. So, unsurprisingly there is little reference to Polanyi in the first volume of Wallerstein.

pression, Fascism-Nazism and Stalinism. *The Great Transformation* is a book about an “age of reconstruction”. As Stiglitz pointed out in the Introduction to the book we have already quoted above, these were fairly radical ideas in 1944. But today it is old news for most institutionalist economists, like Stiglitz himself.

With our experiences of state socialism, we have to push Polanyi’s analysis a little further. Yes, Polanyi was a theorist of a mixed economy, where markets co-exist with other forms of integration. But which form is the dominant one? We believe - and assume Polanyi would be comfortable with such an interpretation – that in a globalized, complex world, the dominant coordinating mechanism *has to be* the market. Polanyi did see the danger of market failures from time to time and the need to complement markets with regulations, some welfare redistribution and/or even more reliance on reciprocity. The 2008 Great Recession and collapse of financial markets were not the beginning of the end of the global capitalist order. These events called for some regulation, which was achieved – in the US, for example – through the 2010 Dodd-Frank Consumer Protection Act. It can be debated whether Dodd-Frank went too far, or not far enough, but except for a few orthodox market fundamentalists, most economists blamed the 2008 financial crisis for excessive, previous deregulation. For Polanyi – who started his adult life as a Christian socialist –, the fundamental task would have been to create enough non-market mechanisms to provide well-being for everyone. Markets often create too much inequality, too much poverty and segregation. Hence, we need well-targeted policies to counteract them. To achieve this, we need social movements and (above all) a liberal democratic system. This was the way he thought about the world.

As this must be clear for the readers of this paper by now, we challenge the hard interpretation of Polanyi. We see him primarily as an advocate of the welfare state and social democracy, and not as a revolutionary socialist who aimed to break up the world system and replace a market-integrated society with one integrated by redistribution. True, he was extremely naive politically (Saval, 2017), he was inexcusably soft during the purges in the USSR during the 1930s and did not stand up against the Hitler-Stalin pact either. Probably, these were gestures to his formerly revolutionary wife. But unlike his brother, who wrote a careful book about the inefficiencies of the early Soviet economy<sup>1</sup>, he did not offer an analysis of the economic system of the USSR. Polanyi was a great economic anthropologist but was a lousy politician. Let’s not damage his scholarly contribution by his often naïve and not well-informed political views.

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<sup>1</sup> Polanyi, Michael (1940).

### *Concluding remarks: an attempt to apply Polanyi's economic anthropology to socialism*

Polanyi never attempted to develop a political economy of state socialism/communism. In what follows, we try to offer a critical political economy of such systems.

Table 2: The main sources of income inequality in socialist and post-communist economies

1. STATE SOCIALISM (ALL STAGES)		
Markets	Redistribution	Reciprocity
(3) → (2) From tertiary to secondary	(1) Dominant	(2) → (3) From secondary to tertiary
During the classical stage, the attempts to eliminate private businesses were prevalent, but not fully successful.  In the reform period, private organizations within state firms and small businesses outside the firms were tolerated.	Redistributors (planners) disposed with the entire "surplus" supposedly in the public interest.*	During the classical period, family networks corrected redistributive failures (e.g. family food production and housing construction); in the reform period, production for markets is allowed to a certain extent.
2. POST-SOCIALIST, ILLIBERAL CAPITALIST REGIMES (ALL VARIETIES)**		
Markets	Redistribution	Reciprocity
(1) → (1.5) From dominant to supplementary	(1.5) → (1.) supplementary to dominant	Tertiary
In the quasi-liberal stage, profits and wages are important. As the system moves to illiberalism and competition is restricted, it loses importance.	The dominant trend in illiberalism is rent allocation to those who are loyal to the executive power.***	The welfare state, which was underdeveloped under socialism, is further cut back. Kinship becomes more important again (childcare and care of the elderly).

Notes: \*Konrad - Szelenyi (1979). \*\* Szelenyi - Mihályi (2020). \*\*\* Mihályi - Szelenyi (2017)

The first author of this paper (Ivan Szelenyi) took on himself this unaccomplished task and used Polanyi's theory to develop the political economy of the actually existing state socialism (with George Konrad ([1974] 1979) and in many later publications). Ilona Duczynska read this book, *The Intellectuals on the Road to Class Power*, when it was still in manuscript (and before its authors were put in jail for it), and she was thrilled: "This is Polanyi, this is Polanyi". The bottom line of the book was that socialist<sup>1</sup> economies were "modern" versions of redistribution. Their integration was redistributive since all the surplus, which could be used for expanded reproduction, was first concentrated in a central hand and was then redistributed to various actors. In archaic empires, redistribution was legitimized by tradition; in 20th-century socialist economies, it was supposed to be guided by the rationality of

<sup>1</sup> Some call it state-socialist, communist, state capitalist – the name is not of major concern for us, as we have already indicated in an earlier footnote.

central planners, or “redistributors”. But this system was greatly distorted, in part, given the information shortages of planners and even more fatally, that these economies were “deeply embedded”. To put it with Mao: under socialism “politics was in command”.<sup>1</sup> Even if economists had had sufficient information and fast enough data processing to respond in time to the changes in the economy, they could have been – and often were - overruled by political considerations.

Tamás Bauer (1978), in a splendid analysis, showed how this system created repeatedly redistributive failures. The “central hand”, the “redistributors” were under pressure from state-owned enterprises (SOEs) for investment funds. Given the political pressures to satisfy as many “consumers” as possible, they tended to allocate those funds too broadly. But funds were still insufficient to finish all ongoing investment projects. So, the center ran out of money, and they had the freeze incomplete investments, which therefore could not generate any income for years. The economy entered into an “over-investment” crisis. Funding had to be cut back until projects were completed, generating revenues, which could be appropriated by the central hand. Once the central hand accumulated enough resources again, the economic cycle of socialism began again, and the redistributor began to throw money at clients.

János Kornai, in his *Economics of Shortage* (1980) – arguably one of the most important books ever written on the political economy of socialism - identified the essence of socialism to tend to chronic shortages. Much like Bauer, he saw an economic cycle in socialist economies, producing extreme shortages, which caused severe crises by reducing those and moving into the next stage of shortages. This is a deeply institutionalist analysis, which offers a comparative analysis of capitalist and socialist economies. While a capitalist economy is driven by a tendency towards *overproduction*, a socialist economy is driven by a trend to *chronic shortages*.

Neither Bauer nor Kornai used the distinction between markets and redistribution, though they were both familiar with Polanyi and our earlier attempts to use his ideas for developing a new political economy of socialism as a redistributive economy. Kornai considered this possibility, but rejected it, mainly because “redistribution” refers to the welfare state, “redistribution” of resources from rich to poor. Hence, he instead used the term “bureaucratic coordination”. Terminology is of little or no significance<sup>2</sup>, nevertheless, there is a fundamental agreement that socialist economies – be they redistributively integrated or bureaucratically

1 In a widely publicized talk during the Cultural Revolution, when Mao and Lin Piao “reviewed 600,000 revolutionary students and teachers and Red Guards” marching at Tiananmen Square, Mao gave the following instruction to his closest followers: „You should put politics in command, go to the masses and be one with them and carry on the great proletarian revolution even better (...).” *Peking Review*, Vol. 9. #47, Nov. 18. 1966. <https://www.marxists.org/subject/china/peking-review/1966/PR1966-47b.htm>, Last time visited: 29 January, 2020.

2 Szelenyi (2009) challenged Kornai by drawing a clear line between „welfare redistribution” (reallocation of market earned incomes) and redistribution of *capital goods* in a dominantly redistributive economy, where the surplus at the disposal of the central hand is not defined by the market. In addition, Weber had a good point when he called “rational bureaucracy” the ideal type of legal-rational (hence capitalist) authority. Szelenyi was critical of Kornai’s suggestion about the “prematurely born welfare state” theory under socialism which had to be reduced in market transition. According to Szelenyi, the problem within socialism was not too much welfare state, but too much redistribution of capital goods.

coordinated - kept producing bureaucratic or redistributive failures in economic efficiency and also in social inequalities.<sup>1</sup>

To follow our soft interpretation of Polanyi, all actually existing societies were mixed economies (though their dominant coordinating mechanism was redistribution). Except for very short, exceptional periods, when attempts were made to eliminate the market altogether, socialist economies needed some market mechanisms to correct redistributive failures (much like market economies need some welfare redistribution and market regulation to control market failures). For instance, even in Castro's Cuba, Stalin's Russia, or Mao's China, when collectivization of agriculture created unbearable food shortages, some concessions were made to food production by family organizations or even some farmers' markets. After 1963, Kádár's Hungary went quite far in allowing the "second economy" first in agriculture, next in other sectors of the economy, but of course, the party-state retained firm control over the industrial enterprise sector of the economy. With such a mix, they substantially reduced – though never eliminated – the shortage economy.

In a mirrored comparison – as David Stark (1996) called it – between capitalism and socialism, it is primarily the dominant coordinating mechanism that creates inequality, and the secondary one compensates for this. This is also true for excessive fluctuations in the business cycle. Excessive inequalities in a socialist redistributive economy are created by redistribution, and those who are "felt out" (for instance, the unskilled rural working class) have to take care of themselves in the marketplace. This is true also for the capitalist business cycle (in 2008, in market capitalist countries' governments with taxpayers' money had to bail out banks, which were too large to fail).

Finally, one last comment on market socialism and democratic socialism. The idea of *market socialism* has been with us for a long time. One of its early formulations came from Oscar Lange (1936), a committed socialist, who saw the inherent inefficiencies of the Soviet economy and believed that it could be fixed by turning it into a market economy. Michał Kalecki (1972), a Keynesian economist who returned to communist Poland after World War II, was advocating reforms along the same lines, by turning socialism into a "mixed economy". One of the most radical theorists along these lines was the Hungarian Tibor Liska (1988<sup>2</sup>), who went as far as suggesting that a market economy is only possible under socialism, since private ownership *per se* is a limitation of free competition.

A related question is whether socialist democracy is conceivable, and the debate about this also goes back to the classics. Marx, in his journalistic work before 1843-44, was a *bourgeois* liberal advocating universal suffrage. He shifted to a revolutionary view of the transition to socialism but had little to say about the relationship between the "dictatorship of the proletariat" and "democracy". In fact, in his 1875 *Critique of the Gotha Program*, he took a stance against a dictatorial transition. By his *State and Revolution* in 1917, Lenin was less shy and

<sup>1</sup> We seem to believe – without hard data – that socialist economies might have produced lower level of inequalities than capitalist ones. The question, however, is what inequality is generated by which mechanism. If inequality is acceptable by the society, the next question is which inequality calls for correction and in what ways (Szelenyi, 1978)?

<sup>2</sup> The manuscript was written some 20 years earlier, just not published due to censorship.

took a harder line on the “dictatorship of the proletariat”. He eventually ended up with the idea of “socialist democracy”, which is a hundred times more democratic than the bourgeois one, which, according to him, is the dictatorship of the minority over the majority, while the dictatorship of the proletariat is the dictatorship of the majority over the bourgeois minority.

As far as the relationship between democracy, markets, and property rights is concerned, Kornai persuasively pointed out that socialism was a system based on three legs:

- public ownership of the means of production,
- redistributive (or, in his terminology, bureaucratic) coordination of the economy and
- one-party rule, legitimized by Marxism-Leninism.

This is a fixed menu, not *a la carte*. These three components are not only logically hung together, but we have not experienced in the last almost one hundred years of experiments, where any of these components could have been separated from the rest. This leads us back to our soft interpretation of Polanyi. The critical question is which is the dominant coordinating mechanism. If it is redistribution, it will come with state-ownership and one-party rule. This is a critical question for our theoretical-ideological political debates today. Chris Hann (2009) regarded Kádárist Hungary as “market socialism” and suggested that it should be shown to socialists around the world that there was a possibility for a functioning socialist dream. While we agree that the Kádárist regime skillfully combined the dominant redistributive mechanism with some market elements and created something that the Hungarians used to call “the merriest barrack in the socialist camp”, this “something” was burdened with terrible political (and to many members of the society, even economic) inequalities, which are unacceptable.

We do appreciate that some older people in rural communities who suffered a great deal during the managed transition from redistribution to a market economy are nostalgic about the previous regimes. But there is no reason for the young generation of left-leaning social analysts to be nostalgic about this epoch.

Many of us – including the first author of this paper – hoped (much like Polanyi himself) during the early 1960s, in the Soviet reform plans, the 1968 Hungarian economic reform, and especially during the Prague Spring of the same year, that “socialism with a human face” may be possible. But history proved us wrong. Kornai was right logically and historically: public ownership goes hand-in-hand with redistribution and one-party rule. China today is somewhat of an exception. There is indeed a great deal of private ownership and arguably quite a bit of market. But given the monopoly of the Communist Party, both are limited and after all China is still a communist country. But this needs more discussion than this paper allows. It is certainly true that the Chinese leaders today allow more private ownership and market than any previously existing communist regimes did.

With the fall of communism, it appeared that “liberal capitalism” was in the making. And it was, but the forms of communist economies were far too “embedded” to allow a liberal system to emerge. As a result, emergent capitalism was, to a large extent deeply embedded in social and political relations, and given the deep roots in political connections, the emergent new post-communist system was more oriented to rent-seeking than profit maximization. Today, most of the post-communist economies are on the verge of capitalism and re-feudalization.

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## 6. China, Eastern Europe and Russia compared

### *Introduction<sup>1</sup>*

Market mechanisms were rarely totally eliminated in socialist economies, but they typically were subordinated to the dominant redistributive integration mechanism of the economy. In some epochs and in some countries, markets played a significant secondary role. An early instance was the “New Economic Policy” (NEP) of the USSR in the 1920s. Yugoslavia opened up space for more markets in the 1960s. Arguably, the most consistent concessions to market forces were made in Hungary between 1963 and 1989. During the 1980s, the authors of this paper (Ivan Szelenyi, 1988 and Mihályi, 1983) considered that Hungary was on its way to a “socialist mixed economy” in which the corporate secretor remained in government ownership and under redistributive integration, but small entrepreneurs emerged from collective farmers and employees in the redistributive sector were eventually also allowed to earn incomes from (often semi-legal) “side-jobs”. Ironically, this produced an unanticipated outcome as far as social inequalities are concerned (Szelenyi, 1978). While in primarily market-integrated economies the major source of inequality is the market itself (compensated by redistributive intervention of the welfare state), in socialist mixed economies, redistribution created the inequalities, and the poor had to try to compensate for this by market transactions. In retrospect, we know that this type of socialist mixed economy was unsustainable, a dead-end street, doomed to failure, which happened in 1989-1991.

China, in December 1978, entered an early process of market transition, which, at least between 1978 and 1985, was somewhat similar to the Hungarian model. Most importantly – and surprisingly for economic theorists of inequality – during the first seven years, social inequalities declined in China. The essence of early reform was careful, gradual de-collectivization. It allowed collective farmers to work in their family work-organization, with fewer and fewer production quotas, and to sell their products at gradually liberalized prices on the farmers’ markets. Hence, the big winners of these early reforms were the rural “direct agrarian producers”. The Chinese reform was eventually broadened to other actors. In particular, the role of Township and Village Enterprises (TVE) (Zhang, 1999) grew over the years. TVEs initially were defined as cooperatives involved in activities beyond agrarian production and with ambiguous property relations, where the local cadres (the state-party *nomenklatura*) joined the beneficiaries, and eventually became the major winners. And indeed, after 1985, social inequalities began to grow again. This was the time when the Chinese model started to face a major ideological challenge “from the inside”. President and General Secretary M. Gorbachev promulgated the concepts of *glasnost*, *uskorenie* and *perestroika*. He also started to democratize the communist party itself. In June 1988, Gorbachev convened the 19th Party

<sup>1</sup> Based on a video message prepared (but not presented) for the Conference commemorating the 40th anniversary of the launch of Chinese reforms and the 30th anniversary of the publication of the path-breaking paper by Victor Nee “Market transition theory”, Renmin University (Beijing), August 27–28, 2019. The written version was published in *Acta Oeconomica* Vol. 70 (2020) Special Issue (2020 - The Year of China), pp. 85–93.

Conference, where the proceedings were televised, and for the first time since the 1920s, voting was not unanimous. In May 1988, János Kádár, the Hungarian communist party leader since 1956, was forced to resign, and a new generation of reformist leadership came into power. In Poland, a massive wave of workers' strikes broke out in 1988. The strikes, as well as street demonstrations, shook the communist regime to such an extent that it was forced to begin talking about recognizing the *Solidarity* opposition movement.

Thus, it was conceivable that China would follow the path towards the breakdown of communism, too, as it happened in Russia and Eastern Europe. But the Chinese Communist Party managed to retain control and avoided the Russian, East European collapse, a full-fledged transition to capitalism and liberal democracy.

Victor Nee, in his path-breaking paper (1989) on "market transition theory" developed a vision of market economy with winners and losers distributed over the whole social hierarchy without posing the question whether this will be "capitalism", or a "transition to democracy" will have to follow the transformation. Hence, we do have here an elegant and precise theory of market transition without assuming that it implies inevitably making of capitalism and liberal democracy. This paper set the agenda for research on China for one or two decades.

### *Three Divergent Pathways after 1988-1991*

The critical point of our paper is that the countries that identified themselves for decades as "socialists" entered divergent trajectories. In our recently published book (*Varieties of Post-communist Capitalism*, Brill 2020) we identified three market transition pathways from socialist redistributive (centrally planned) economies. Such divergences were unanticipated since, during socialist times, all these countries seemed to be on a convergence trajectory.<sup>1</sup> In the 1990s, it still appeared that the "*long duree*" effects had returned.

As we mentioned already above, in 1989-91, the previous system of the European socialist countries spectacularly broke down. They were all heading towards capitalism, and most of the Central European countries moved towards liberal democracy, as well. In June 1988, China was at a turning point too, but rather than turning towards liberal democratic capitalism, it moved away from the reforms of 1978. It was only after the "Southern tour" of Deng Xiaoping in early 1992, when he persuaded the other leaders to return to the road the reform, but without a full-fledged transformation to capitalism and liberal democracy.

So, China insisted on remaining "market socialist with Chinese characteristics" and at least until 1998-1999 it looked like "capitalism from below". One of the authors of this paper (Szeleényi, 2010) analyzed to social origins of the top 10 Chinese wealthiest people and found that only one of them came from the elite, while all the others came from humble origins (farmers, bricklayers, etc.). Several Chinese researchers – for instance, Lu Peng (2017) and

<sup>1</sup> With the benefit of hindsight, one should have paid more attention to the fact that China, after she clashed during the late 1960's with the USSR both ideologically and militarily, followed its own course in many ways.

his co-authors in recently published articles - found similar tendencies though they reported a much more diverse background for the Chinese new rich.

In our forthcoming book, we suggest that by the year 2000, many of the former European socialist countries “imported capitalism from the outside”. In other words, the capitalist transformation was driven by foreign direct investments (FDI) - first in Hungary but soon followed by Poland, Slovakia, the Baltic states and recently Romania. The commitment to the ideals of liberal democracy and the European Union was especially strong in what was commonly called Central Europe (the “Visegrad-4” and the Baltic states, the former sphere of German influence).

The third pathway we observed in Russia, and we labelled it “capitalism from above”. This meant - *inter alia* - state-led privatization, offering advantages to clients of the political elites (or even enriching the elites and their families). Unsurprisingly, the former Soviet Republics in Central Asia followed the Russian model closely.

As China began to enter into the privatization of the state-owned enterprise sector in 1998-99 and the social composition of the wealthiest Chinese began to change as well, with the “princelings” accumulating substantial private wealth, we began to wonder whether China is *not* converging to the Russian way of “transition from above”. Victor Nee already in 1999 speculated about a hybrid state in China but reconfirmed his faith in the “capitalism from below” model in his wonderful book (Nee - Oper, 2012), emphasizing the dynamic character of private entrepreneurship in Chinese development. Nevertheless, the official doctrine in China remained “socialism with Chinese characteristics”.

### *Re-convergence in illiberalism? Is this Putin’s or President Xi’s model?*

#### *Recentralization in China*

China, of course, was never a liberal democracy - never claimed it to be one and always refused to be called capitalist. Those who believed that China actually did become capitalist, however, typically accepted that it would eventually become a liberal democracy as well, because they were convinced that capitalism can only co-exist with liberal democracy.

Western liberal economists proved to be naïve, to say the least. Today, 40 years after the beginning of market reforms in China, we can confidently assert that she is nowhere near the Western concept of liberal democracy. In June 1989, China made a clear commitment to resist the temptation of liberal democracy. Whether in any meaningful way she became capitalist is still hotly debated, mostly by Chinese, but also by some Western scholars. Can a country ruled by a Communist Party be called capitalist? This question directly follows from the *magnum opus* of János Kornai (1992), entitled *The Socialist System*, which defined “socialism” with three equally important building blocks:

- (i) public ownership of the means of production,
- (ii) redistributive integration of the economy and
- (iii) the rule by a communist party.<sup>1</sup>

China undoubtedly experienced some degree of “liberalization” (especially in the business world, there was substantial change towards to “rule of law”). For example, in rural communities in the 1990s, a corporatist arrangement emerged between local government, business and popular interests (Oi, 1992 and Lin, 1995). But China has certainly not been turning into a “legal rational authority”<sup>2</sup> and never considered nationwide elections to the legislature on anything resembling universal suffrage. Nevertheless, there has been some significant “internal democracy within the party” (promoted by President Hu, in office between 2003-2013):

- (i) The *Standing Committee of the Politburo*, consisting of 5-11 members, exercised substantial influence and articulated various interests.
- (ii) The president had a term limit and could be elected only twice, he shared some power with the prime minister, and
- (iii) their successors were appointed early, and then they played some role during the second term of the President and Prime Minister.

On the Contrary to the above said, in China recently, we saw the reinforcement of the central authority. While during the 1980s there was substantial decentralization (Yang, 2016), during the latter part of the present decade, the authority of the central executive branch has been substantially increased. An important move in the same direction was when the constitution was amended in 2018 to allow the president to serve for life, without any term limit. Many commentators believe that President Xi has more authority than anyone had since Mao, and probably, he has more influence on the Standing Committee than previous party presidents. Recentralization and reinforcement of the authority of the Party were, on the other hand, not a “break”, just a continuation of the Chinese way of “power-sharing”.

In Russia, by contrast, after 2000 and in some Central European countries during the past 10-15 years, there has been a rather clear shift from the way they experienced transformation after 1989-91. This shift was primarily in politics, but with some implications for the economy as well. To be clear, the capitalist nature of post-1989-91 Russia or Central European capitalism was never in doubt, but given the important changes in the political system, arguably the way *how* their capitalist economy functions is deeply affected.

#### *Changes in Russia: from Yeltsin’s “wild East capitalism” to Putinism*

Let us first address the question of political-economic changes. In this respect, the first 10-15 years of transformation were quite different in Russia. President Yeltsin’s system created a “wild East” type of capitalism. Russia was committed to rapid changes in property relations

1 As a matter of fact, Kornai put the unlimited rule of the communist party on the very first place.

2 This is a term we borrow from the German 19th-century sociologist, Max Weber.

without much possibility of interference for foreign investors. Yeltsin's political slogan was "we do not want to create a few millionaires, but we aim at the creation of millions of owners".

The major mechanism of privatization was through privatization checks (vouchers or coupons), which eventually led to the emergence of a rather small class of oligarchs. While public property was distributed broadly among the population, most recipients without experience of entrepreneurship and capital, sold their vouchers to a few people, well-connected to the Kremlin, who in publicly manipulated auctions *de facto* appointed a new *grand bourgeoisie* from people whom they expected to support them politically. Yeltsin acted as the "godfather of the Kremlin", to put it in terms developed by Paul Klebnikov (2000). These oligarchs soon began to privatize the state itself, which led to state failure on a grand scale and to an anarchic, oligarchic type of capitalism. While Yeltsin during his first one or two years of his presidency appeared to be sympathetic to liberal democracy, he soon clashed with the democratically elected Parliament (the *Duma*) and shut down the constitutional court, hence there was no democratic opposition to the oligarchic chaos which followed. Vladimir Putin, in 1999-2000, took over a failed state and a bloody war in Chechnya. Very early on it became clear that he would crack down with an iron hand on those oligarchs who were not his loyal followers. While during the first few years of his presidency, Putin was perceived by many Western commentators as a reformer aiming at market capitalism and liberal democracy, soon it became clear that he instead tried to establish himself as the "good tsar", creating a strong executive with virtually no divisions of power. He promised to "make Russia great again", to restore its greatness of the Tsarist times. In his aspirations, he found an ally in the Orthodox Church. While the price of oil was booming, a large middle-class benefitted from his strong executive will. But as the economy was turning down, he needed to gain popular support with an appeal to Russian ethno-nationalism, orthodoxy, and imperial ambitions, as it became obvious with the annexation of the Crimea and the proxy war in the Ukraine and other foreign policy adventures (including intervention in the 2016 US election). Putin is not restoring the USSR (his ideal is Tsarist Russia), nor does he restore socialism. He established a firm executive control over the political process.

He basically runs a "one-party system", and while multi-party election takes place regularly, they are highly managed in favor of the "United Russia" party, with no substantial organized opposition whatsoever. The executive branch has almost complete control over the judiciary, and while opposition media is marginally tolerated, opposition journalists and politicians are threatened (occasionally killed under unclear circumstances). Private wealth is respected, but also increasingly under the control of the executive, with occasional re-nationalizations and advantages offered to rent-seekers (more about this in Mihályi and Szelenyi, 2019) of loyal entrepreneurs or even family members. Putin created a system which looks very much like what Hungarian Prime Minister, Viktor Orbán called in a famous speech in 2014 "illiberalism".

### *The rocky roads of European former socialist countries, from liberal democratic capitalism to illiberalism (1990-2005, 2006-2019)*

This takes us back to the former socialist countries of Europe. In the above-mentioned talk, Mr. Orbán launched an attack against “liberalism”. In his view, liberalism puts excessive emphasis on individual liberties and does not represent the national interest effectively. Hence, he recommended replacing “liberal democracy” with “illiberal democracy”.<sup>1</sup> In liberal democracies, particularistic interests can delay or even block practical executive actions for the national interests. In Orbán’s vision, illiberal democracy retains regular multi-party elections, but much like in Putin’s version, it assumes a system of “national cooperation”, with a strong “central force field” by his own party (it is called Fidesz). The essence of the system is an effective executive branch, which is not limited or paralyzed from time to time by other branches of power, like the judiciary, media, or even social science research, as according to Orbán may be the case in liberal democracies. This illiberal regime is deeply capitalist, but the economy - much like the political arena - is “managed”. The most important mechanism for such “management” is the regulation of the markets – especially investment markets (including public procurements). Since the executive is supposed to have privileged knowledge of what market outcomes are in the national or common interests, it can give market advantages to those actors who are supposed to act for such interests. One is not supposed to leave market transactions to blind profit-seeking behavior. Those once selected for a privileged position on those regulated markets (for instance, domestic players versus foreign investors, among domestic players, those who are more trustworthy for the executive, and in particular for the chief of the executive branch) are rewarded with rents, rather than just receiving profits for their entrepreneurial spirits. This way, *the profit-seeking* behavior of market actors is replaced by *rent-seeking* (Mihályi – Szelenyi, 2019). When the selection of awardees of such rents is based on bloodline or adapted family kinship of the chief executive, such choices may be called “corruption”. This Hungarian system, based on these grounds was labelled by a Hungarian sociologist (and former Minister of Education), Bálint Magyar (2013) as “mafia state”.

### *Postscript: An illiberal international? The scope and limits of illiberal conversion and global capitalism*

The tendency to liberate the executive and especially the chief executive from paralyzing forces of particularistic interests and the transition from liberalism to illiberalism may have been invented by Putin (or President Xi, or even some of his predecessors), but this is a trend well beyond those two big countries. Among the former socialist countries of Eastern Europe, Hungary follows closely such a political and economic transformation, but the “Putin virus” is present in most post-communist countries of Europe (in Poland, in the Czech Republic, in Romania, Bulgaria, and most of the other Balkan states) and well beyond the post-communist

<sup>1</sup> Most recently – see Orbán (2019) -, he identified this as “Christian”, rather than “individual” freedom, claiming that Christian democrats are also “illiberal”, what no West European Christian Democratic Party would accept.

world. The strengthening of the executive branch and the desire to enable it and its executive to act effectively, which they define as the “national interest”, is evident in Erdogan’s Turkey, in Trump’s USA, it drives the Brexiters in the UK, and clearly observable in Bolsonaro’s Brazil or in Modi’s India. Is the world now entering an epoch of illiberalism? Is this the inverse of Fukuyama’s “end of history” concept (1989), the final victory of liberal democratic market capitalism?

Hard to tell. We may experience a rather short-term cycle of political fortunes. Leaders of illiberal regimes gained electoral success by promising to defend ethno-national interests against the forces of globalization and “dry the swamp” of bureaucratic politics of liberal democracies. President Xi, Putin, Trump, Erdogan, Bolsonaro, Prime Minister Orbán or Modi can indeed act swiftly since they do not have to go through the painful, costly, and lengthy process of negotiation with various interests. This looks like success.

Nevertheless, there are critical shortcomings of illiberal regimes as well. The speed at which decisions are made is not always matched by sufficient and sufficiently high-quality and diverse information that liberal democracies operate with. The swift, but not always the best-informed decision, may not produce the best possible outcomes. Furthermore, while the appeal to exclusive ethno-national radicalism may be a formidable force to mobilize people (and electorates), it may contradict the powerful – and possibly overwhelming – forces of globalization. There can be only global answers to the crucial challenges the world is facing today: environmental degradation, the uneven demographic change across continents, and the free flow of capital around the world. China first, Russia first, USA first, Hungary first, etc., may help chiefs of executives to consolidate their power and even to win elections at home – if they seek elections at all – but they may not be the most appropriate foreign policies for the 21st century. The forcefully acting executives with their exclusionary ethno-nationalism eventually may have to settle once again with a more globalist view of our problems and sacrificing the speed of sovereigntist decisions for a nationally and globally more multilateral, slower, but at the end better informed process of decision making.

Fukuyama (1989) was right on target. Indeed, for the following 15 years, as the Freedom House institute reported, the number of countries that were classified as “free” was increasing, and the proportion of “unfree countries” declined. But then, President Putin, in his annual address in December 2013, called for the formation of a new “international” around his policies. Nowadays, liberal democracies are retreating, and illiberal regimes are ascending. In May 2019, European anti-migrants, exclusionary ethno-nationalists from the Italian Salvini to the French Marie Le Pen and Viktor Orbán from Hungary were all hoping for a breakthrough and the formation of a large enough fraction of their own in the European Parliament so they can shape European politics. While their parties did well at home, and both the social democrats and the people’s parties lost ground, the big winners were the Greens and liberals. The prospects of an illiberal international order are not great today. Their main protagonists are all nationalists with particularistic national (and imperial) interests. Trump expressed admiration (even love) for Putin and Xi, but the US, Russia, and China have structural/imperial conflicts. Salvini and Orbán equally hate “migrants”, but Salvini would like to send them from Italy to Hungary (and to other European countries), which is the least that

Orbán wants. The Polish strong man, Jaroslaw Kaczyński, is just as illiberal as Orbán, but the Poles intensely hate Russians, while Orbán's Hungary is Russia's best friend in the European Union. In other words, ethno-national illiberalism and illiberal internationalism are direct contradictions in terms. Only “*transnational liberalism*” can be international and address in multilateral ways the global challenges of the world.

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## 7. Introduction to the Russian Edition of Varieties of Post-communist Capitalism

### *This book has a long history<sup>1</sup>*

The two authors of the present book are extremely pleased to see their work being published in Russian. Although English has become the *lingua franca* of economists, it is still true that through the Russian language as a transmission mechanism, a very large number of colleagues can be reached throughout the 15 former Soviet Republics, a very important part of the post-communist world, the subject of the present book. The truth is that this book was in the making for a very, very long time. Ivan Szelenyi became interested in post-communist capitalism at the very beginning, i.e., in 1990. Then it appeared that countries, which were rather different during communist times – think of China, Russia, Cuba, Hungary under Janos Kadar, etc. - all converged towards the classical system of liberal capitalism. But this convergence did not last for too long. Some post-communist countries went their own way – just as the *varieties of capitalism theory* (Hall and Soskice, 2001) conceptualized later. Given the rapid changes and especially the complex economic transformations, the first author's (Ivan Szelenyi) original manuscript was left incomplete until Peter Mihályi joined him to produce a publishable book by 2020. After almost a decade of joint work, the two authors share the same responsibility for the virtues and errors in this book.

Unsurprisingly, the history of the post-communist countries did not stop in 2020 when the original, English version of the present book was published by the prestigious international publishing house, Brill. These changes, which took place in the last *two years*, went beyond this; they have had far-reaching implications for the entire world, including the United States and Western Europe as well. The war in Ukraine created a situation in which the use of nuclear weapons and the possibility of a Third World War have become tangible risks.

Let us look at Russia first. Given its extraordinary oil wealth, during the first years of the 21<sup>st</sup> century Russia did well economically. It had resources to rebuild its *army*. It looked like Russia was back as a major empire. Given the heavy reliance of Russia on oil and gas, and its poor performance in manufacturing, President Putin's hope to compete with the EU and the USA was questionable, but not unreasonable. When our book came out in English, we did not (and could not) know what the value of Russia as a military power is. It is obvious only today (January 2023) that Putin made a serious mistake when he attacked Ukraine by justifying it with the claim that all states of the former USSR should be treated as a legitimate sphere of influence of Russia. It is only today a commonplace that Putin's intention since 2014 was to incorporate Ukraine as a Russian province, and he did not appreciate much Ukrainian identity, even though Russian speakers have. The irresistible invasion planned for a few weeks has

<sup>1</sup> Published in Russian as an introduction to our book. Date: January 14, 2023. The original draft was prepared in English. (*Varieties of Post-communist Capitalism: A Comparative Analysis of Russia, Eastern Europe and China*, 2019 Brill), pp. 23-34.

already so far more than a year. The worst news for Putin was the miserable performance of his army. It is estimated that 100,000 Russian troops have died or been

injured so far. After its unquestionable military successes in Syria and elsewhere in the Middle East and Africa, Putin's army suffered an unquestionable and devastating defeat when it tried to occupy Kyiv. Russia was also hurt by Western trade and financial sanctions. By contrast, Russia's oil embargo and its one-sided limitations of gas deliveries did not seem to hurt Europe substantially. Putin's official excuse (or explanation) for this unprovoked act of aggression was that he wanted to 'de-nazify' Ukraine. But not even the president himself could believe this nonsense for a minute.

*Changing goals: From the Communist International to the restoration of the Great Russian Empire*

Very early on, Szelenyi (1990)<sup>1</sup> offered an alternative interpretive framework for the quintessence of post-communist transition in a short, Hungarian-language article, which remained unnoticed even in Hungary. Is it possible that, he argued back then, that in the case of some countries, the first milestone of post-communist transition is not going to be a move towards liberal democracy, but rather Balkanization, nation-state independence (nation-building) from the Soviet Union, and a return to the national goals and legends of past centuries.

Why does all this matter today? Let us recall that Lenin and Trotsky imagined that the Bolshevik Revolution that took place in the USSR would become a world revolution. Very significantly, the anthem of the Soviet Union was for decades the anthem of the Communist International. Over time, however, Stalin was forced to moderate these world revolutionary aspirations. He accepted that in the foreseeable future, the communist revolution could and should be carried out in a single country. But since he himself was not Russian, Stalin, in agreement with Lenin, who passed away in 1924, imagined the Soviet Union as a multilingual, multi-ethnic country. Occasionally, he gave in to Russian nationalism, but he acted against certain nationalities. For example, he relocated Tatars, Estonians, Lithuanians, Jews, and Germans to Siberia. But Stalin's Soviet Union was not and did not want to be the embodiment of the great Russian empire - in contrast to President Putin's nostalgia for the Soviet Union, which is now not even secretly mixed with the dreams of Peter the Great.

Throughout the 1980s, very few thought that the wheel of history could be turned back. Yet, a few years later, everything changed. Around 2010, after the border changes, 38 countries already formed the group of „transitional economies”. At that time, it still seemed clear that both Russia and even China were moving rapidly towards becoming a market economy and, to a certain extent, liberal development. The dominant interpretation framework of the regime changes that took place in the countries of the communist world system in 1989/90, at the dawn of the changes, was developed by Francis Fukuyama in his study *The End of History*. Generalizing the lessons of the 1980s, the American political scientist of Japanese origin formulated the proposition that history is an evolutionary process, the current stage of which is the state when liberal democracy as a form of government is the *only* desirable model for all countries in the world. The leaders and opinion-forming intellectuals of the countries saw

<sup>1</sup> Ivan Szelenyi: „Social costs of post-communist transition”, *Magyar Nemzet*, 15 September 1990 (in Hungarian).

that the ideological competitors of liberal democracy, fascism and communism, had failed, and imagined that it was only a matter of time before the idea of liberal democracy, as an economic, scientific, cultural, military, etc. system, triumphed everywhere - including the former communist countries.

Looking back from today, it is clear that Szelenyi's interpretation mentioned above did not attract attention even later, because the two most important ex-communist countries, Russia and China, but also the Baltic countries, Poland and Hungary, at least during the early 1990's, to a great extent were committed to liberal democracy. Their national economies opened up to the West in the dimension of international trade, privatization took place, and several countries joined NATO and the European Union. What's more, even Russia and Ukraine joined the cooperation forum of the NATO Partnership for Peace program. Up until the beginning of the 2010s, the two countries signed numerous agreements with NATO.

Until February 2022, the cumulative losses of post-communist military confrontations were relatively moderate. There were about 50 military clashes in the Balkans and on the territories of the former Soviet Union, but until the Russian-Ukrainian war, it seemed that these combats were limited in time and space, and there was no question of the use of weapons of mass destruction. As a matter of fact, Russia even reduced its nuclear arsenal; Belarus, Kazakhstan, and Ukraine „returned” their nuclear weapons to Russia. All in all, it seemed that humanity got off cheap in the post-communist transition. Viewed from Berlin, Paris, London or Washington, it seemed for a reason that the number of conflicts and the number of victims dwarfed those of World War I or World War II, or the projected human sacrifices a Western attack against the USSR would have generated. The so-called Russian-Ukrainian war (it also could be called as Putin's aggression against Ukraine), which broke out in February 2022, brought about fundamental changes in the international balance of power due to the *size of the two countries*. The largest country in Europe by area attacked the second largest country on the continent. On the other hand, a completely new situation arose because the United States and the European Union became (*de facto*) belligerent parties with arms shipments, sanctions against Russia, and the expansion of NATO. The Sino-Russian rapprochement also seems to be an important development. It has offered an exceptional window of opportunity for China to annex Taiwan, and for North Korea to send up to 100,000 volunteers to Ukraine as cannon fodder to support the Russian army. *Since the Cuban Missile Crisis of 1961, humanity has never been so close to a nuclear World War III.*

In our view, the fundamental reason for the outbreak of the war is that the regime change for Russia did not bring the hoped-for result, the economic catching up with the West. Moreover, Moscow has, in many dimensions, found itself in a worse situation than it was in 1989, immediately after the loss of the Cold War. This is why Putin could say already in 2005 that the dissolution of the Soviet Union, from Russia's point of view of, was the biggest geopolitical disaster of the 20th century. Ukraine's economic performance appeared to be even worse than that of Russia. Demographic changes, for example, showed a worrying picture. While in the last 30 years the population of the world has increased by 40%, that of the United States by 30 %, and that of China by 20%, the population of Russia has stagnated and that of Ukraine has decreased by 20 %.

Compared to Russia, Ukraine seemed much weaker militarily, so it was logical from Putin's point of view that he wanted to test the probably decade-long program of violent restoration

of some kind of Great Russia with Ukraine. The stronger attacked the much weaker. This is the main rule of evolution, or as Putin put it in a nostalgic interview in 2015: „50 years ago, the streets of Leningrad taught me a very important lesson: if a fight is inevitable, you must strike first”.

Vladimir Putin, the incumbent Russian president, ultimately believes that the Soviet Union was the same as Peter the Great’s Russian empire. The member states of the Soviet Union had no sovereignty; they were member-states of the Russian Empire. This had a basis in reality: in the member states of the Soviet Union, everyone who wanted to achieve something had to learn Russian, and many Russians also immigrated to the „new” member states (even to the three Baltic countries, where the national consciousness remained perhaps the strongest).

Ukraine was particularly important in this respect. The Ukrainian language is close to Russian, and on this basis, Putin began to doubt whether a Ukrainian state and language still existed on February 24, 2014, when Russian troops captured strategic sites across Crimea, followed by the installation of the pro-Russian Aksyonov government. Ever since the war has been going on, in the speeches of himself and his confidants, Putin no longer hides the fact that his real ambition is to be the new Peter the Great, to restore the great Russian empire that Peter the Great had created in the 17<sup>th</sup> century.

Peter the Great was indeed one of the greatest tsars in Russian history. He differed from Stalin’s favorite tsar, Ivan the Terrible, in one important respect. Both Ivan and Peter played an important role in breaking down the power of the boyars, and to that extent they took an important step in building an efficient - and we could even say „modern” - state. They used everything to achieve this goal (Peter - according to the legends - personally beheaded the boyars who contradicted his authority).

But while the Stalin - Ivan, the Great parallel is authentic, the Putin-Peter the Great is inaccurate. In his ruthlessness against the oligarchs, Putin can be compared to Peter, but the Russian Empire he dreamed of was not only supposed to be large and strong, but also (Western) European. As is well known, Peter the Great traveled the world for years under an alias, in disguise, in order to learn how to govern a country in a European manner, and as a statue of this ambition he built St. Petersburg, the most European Russian city, whose European character is neither Soviet rule, but still even the terrible Second World War could not completely eliminate it.

Putin, therefore, sees himself as Peter the Great, whose historical task is to restore the Great Russian Empire - using all means, including the Orthodox religious traditions. He gets a lot of support for this in Russia - his popularity was around 80 (even the latest figure is 72 %) % when the Crimea was seized -, but his possible international partners do not support him. Turkey is skeptical; the Central Asian countries are more aligned with Turkey. China also does not want to see a too strong Russia in Siberia. Put another way: the fundamental self-contradiction of Putin’s concept is that *the Slavophile, ethno-nationalist, Pravoslav ideology and Putin’s cult of personality are unacceptable to most of the Soviet successor states* - the Near Abroad, a Russian colloquial term used to denote the countries of the former USSR. Going beyond the borders of the former Soviet Union – the Far Abroad in Russian parlance -, countries can only have limited sovereignty where Russia maintains what then-President Medvedev called “privileged interests [privilegirovannye interesy]”. These countries should be

“neutral” – whatever it means. This concept goes against the logic of the post-1945 international agreements and is therefore unacceptable for Finland, Sweden, Poland, etc. (The nationalist Hungarian government is silent about this question). At the outbreak of war, Putin hoped to achieve two formally stated goals: (i) NATO would not accept new members. (ii) NATO troops may not stay in the future in countries that joined the Western military alliance after 1989. These two goals were dropped from the agenda during the first few weeks of the war.

There is another significant problem with interpreting the Soviet Union as Great Russia. The Soviet Union had a false (and never accepted by many), yet attractive to many, universal, atheistic ideology, namely the idea of liberating all of humanity, *the ideal of communism*. This fit well with the model of a multi-ethnic, federally organized state, and with the fact that some of the leaders of the Soviet Union were not even born in Russia and/or were not of Russian nationality on both their fathers' and mothers' side, and did not follow the Orthodox faith (Stalin, Trotsky, Dzerzhinsky, Beria, Khrushchev, Gorbachev, etc.). It is now forgotten, but it is a fact that in August 1991 – after the failed coup against Gorbachev – Yeltsin, as the President of the Russian Federation, unexpectedly banned the Communist Party of the Soviet Union (CPSU). It's not as if Gorbachev was a staunch communist, but – like China's Deng Xiaoping – he probably thought at that moment that the CPSU was necessary to keep the Soviet Union together. He was probably right at that historical junction, but he was overruled by Yeltsin.

### *Putin's power is weakening*

With increasing military setbacks in Ukraine and under the influence of Western export sanctions, the Russian economy contracted, and this made it increasingly difficult for the army to replace its best arms. Putin seems to be in some domestic political problems, too. He appointed Sergey Surovikin in November 2022 as the chief of staff for the war in Ukraine. Surovikin is also called “general Armageddon” given his tough military rule in Syria. He was removed from the office just three months later, a sign that Putin has problems with his own staff. Surovikin was a close ally of the Chechen leader, Ramzan Kadyrov, who already urged the use of tactical nuclear arms in Ukraine, and Yevgeniy Prigozhin, who assumedly runs the paramilitary group called Wagner Group. Simultaneously, he appointed Valery Gerasimov, a close ally of the Minister of Defense, Sergei Shoigu, both assumed to be less aggressive in the Ukraine. This may not imply a change in Putin's Ukraine policy, but it proves power struggles within the top military leaders in Russia. In January 2013, Putin also attacked on live television Denis Manturov, the sitting minister of defense industry, an unusual act by a president. The opposition and the Western Press, including *The Guardian*, began to speculate once again about a possible coup against Putin.

### *China is still faithful to the communist ideology*

Compared to this, a decisive difference is that the Chinese leadership did not give up the communist ideology and the leading role of the Communist Party of China (CPC) even for a minute. The party still has 96 million members today! It is true that in practice the concen-

tration of power and the cult of personality of President Xi Jinping and Putin are not much different, but the huge difference is that the Russian leadership cannot legitimize its own power with anything other than referring to Russian national interests. To be stylistic, we do not even understand how Putin imagines that the people of the successor states of the former Soviet Union and the current leaders of the former Eastern European vassal states – including the Hungarian Viktor Orbán, Putin's closest ally in the post-communist world - are willing to accept the slogan "Russia first".

But President Xi has his share of problems, even if they are not as serious as Putin's. After months of demonstrations – rather unusual in China – Xi had to abandon his "zero Covid" policy. The "zero Covid" policy, with massive closures and insufficient vaccination, caused serious economic problems and led to isolation and anger among ordinary people. Xi ignored the demonstrations for many months. But they were becoming more violent and began to pose political demands (for instance, on some occasions, people called for Xi's resignation and for more democracy). We are not quite there, where China was in 1989, when perhaps 1 million people demonstrated at Tiananmen Square for weeks, but the story began to move in that direction. It remains to be seen whether Xi's abandonment of "zero Covid" came still in time and was sufficiently radical.

Nevertheless, it is obvious that Xi, to some extent, is a disappointment. He was elected as president in 2013. As a victim of the Cultural Revolution, he also promised further economic reforms. But in 2018, rather than nominating his future successor (that was the way China operated since the fall of Mao), he changed the constitution and allowed him to be elected for a third time, and in principle to stay as president for life, hence abandoning even the appearance of democracy. Since our book came out in English, we have not seen much of economic reforms; on the contrary, he strengthened the public sector and crushed down on some of the private entrepreneurs. Unsurprisingly, the Chinese economy performed worse during Xi's term than under his predecessor, President Hu Jintao. As James Palmer, Deputy Editor of the American journal *Foreign Policy*, wrote in December 2022, "Xi starts his third term with failure upon failure".

Otherwise, Xi follows Putin's tactic by calling on people's nationalism to rally people behind him against a sizeable enemy (in his case, this is Taiwan). His domestic problems are not as deep as Putin's, but he is vulnerable domestically as well. It was symbolic that his popular predecessor Hu was escorted by force from the CPC party congress, unheard – and unexplained gesture in the Chinese communist party. James Palmer suggests Xi's rise to power had a lot to do with the fact that he was a "boring" but competent politician. For the time being, we have seen little from his competency. The few European politicians – like Viktor Orbán in Hungary or Aleksandar Vučić of Serbia - take a lot of risk when they bet their foreign policy future on collaboration with Putin and Xi rather than with the EU and the USA.

## RENT THEORY APPLIED

### 8. Kornai on the affinity of systems: Is China today an illiberal capitalist system or a communist dictatorship?

#### *Introduction*<sup>1</sup>

In 1979, János Kornai introduced his famous supermarket metaphor to challenge the theory of the “third way”, an *optimal* and *sustainable hybrid* between capitalist and communist policies. Socioeconomic systems, he argued, cannot be constructed from randomly or scientifically selected pieces, similar to customers in a supermarket, who are free to put into their shopping trolley whatever they find on the shelves. Structures, like socialism<sup>2</sup> or capitalism, are not made of separate building blocks fixed together with screws or mortar. Their interrelatedness is like a genetic program of procreation. All newborn cats are similar to each other, whether small or big. In the same way, all socialist (or capitalist) systems are somewhat similar to each other. In several later works, Kornai formulated the same idea as the “affinity thesis”,<sup>3</sup> according to which the bureaucratic model of coordination has a natural affinity for (strong linkage to) state-owned property, while market coordination has a natural affinity for private property. By contrast, the linkage between market coordination and state property is *weak*, meaning that one cannot use the market as a neutral instrument to promote state ownership.<sup>4</sup>

The objective of the present paper, based partly on our new book (Szelenyi and Mihályi 2020) is to advance further Kornai’s affinity thesis on the example of China, about which Kornai himself has published quite extensively and spoken often in interviews since 2014. Kornai’s initial position was that China was a *capitalist dictatorship*. The Communist Party was communist only in its name, he asserted; it was more nationalist or Confucian.<sup>5</sup> In the present paper, by contrast, we shall elaborate on Kornai’s more recent position (Kornai 2019a). China

1 First published in *Public Choice*, Vol. 187, Issue 1-2, April 2021, pp. 197-216. Special Issue, Published online: 27 July 2020. This was a special issue in honor of Kornai, edited by Mehrdad Vahabi.

2 Taking our lead from Kornai (1992, 2016), we use socialism and communism as synonyms throughout this paper.

3 The term comes from Max Weber’s “elective affinity” (*Wahlverwandtschaften*; think about the plural in the German expression!), but for Weber, that term was not supposed to be a causal relationship. It does not imply that no choices are available; it means only the likelihood that one system characteristic will match another. In the early formulation of Kornai, “affinity” read like an inevitable, causal relation. To put it another way, the question is whether we have a set *prix fixe* menu or *à la carte*. Well, some restaurants offer fixed menus with multiple choices of main dishes. China is an excellent example of a set menu with multiple main dish options. Kornai, as a good social scientist and faced the realities of the Chinese economy and society, adjusted his theoretical frame, as we will show in this paper.

4 In his Memoir, Kornai (2006, p. 282.) recalled that he had used the supermarket metaphor for the first time in the Q&A part of his 1979 Geary Lecture in Dublin. In the edited version of the lecture, that point was already elaborated in more detail at the essay’s end (Kornai 1980).

5 For a similar position, see Bell (2008).

between 1978 and 2013 resembled non-electoral, authoritarian capitalist regimes like Russia, Iran, or the Gulf monarchies. Elections are held, but the political rulers manipulate the electoral system in many ways, so the outcome is not competitive. It is always the incumbent ruler who wins. Present-day China, under the leadership of Xi Jinping, is increasingly returning to *communist, dictatorial practices*. The regime retains and even extends governmental interference into markets and private property (which was substantial even in the earlier phases of the reform<sup>1</sup>). In the light of Kornai's supermarket metaphor, such a system may become unsustainable. Whether it is untenable or not remains to be seen. Only history can tell, but Kornai's theory predicts eventual failure.

At the time of submitting the final manuscript of the present essay (May 2020), when the entire world is occupied with the fight against the *coronavirus*, such a "categorization game" is very relevant for the interpretation of President Xi's "people's war against the epidemic with the most comprehensive and rigorous measures".<sup>2</sup>

### *The end of history?*

In a path-breaking article, the American political scientist, Francis Fukuyama (1989) predicted "the end of history" and the *final victory of the Western-type liberal, capitalist system*. He wrote it in a few months between November 1989 (the collapse of the Berlin Wall) and the beginning of Boris Yeltsin's rule in July 1991 (as president of the newly "re-created" Russia). But history continued. Fukuyama's point of departure was the fall of communism, the only historically proven, 20<sup>th</sup> century viable alternative to the capitalist market economy and liberal political systems. (Fascism, the other abysmal alternative to liberal democracies, proved to be relatively short-lived from the 1920s until the 1970s.<sup>3</sup>)

Indeed, as Szelenyi and Mihályi (2020) explained, 70 years after Russia's Bolshevik Revolution, 26 socialist countries spanned more than 31% of four continents. Their combined populations in 1987 amounted to 34% of the world's total. Then, unexpectedly, on November 9, 1989, half a million people gathered in East Berlin in a mass protest; the Berlin Wall dividing communist East Germany from capitalist West Germany crumbled. Within a few months, the communist system disappeared from Europe, and the two Germanys were united. And, indeed, the first 15 years following the publication of Fukuyama's seminal article saw a spectacular retreat of socialist systems worldwide and the expansion of freedom and liberal democracies. The most persuasive argument for an optimistic interpretation of ongoing history was the rela-

1 Before the U-turn, Nee and Opper (2007) called China "politicized capitalism". Huang (2008) wrote about "capitalism with Chinese characteristics".

2 A direct quote from the communique of the Chinese foreign ministry on the content of President Xi's phone conversation with US President Donald Trump on 7 February 2020.

3 Fukuyama was extrapolating the analysis of his mentor at Harvard, Samuel P. Huntington, who wrote an agenda-setting work on what he called "the third wave of democratization". Huntington's point of departure was the 1974 anti-fascist revolution in Portugal and the death of Spain's General Franco in 1975. See Huntington (1991), although by 1996, Huntington's optimism was fading, and he began to see a new world disorder, not based on competition between capitalism and socialism, but between Western liberal democracy and other illiberal systems not necessarily conducive to capitalist development.

tively peaceful disintegration of the Soviet Union (and with that the liberation of the three Baltic states), but the changes in China offered the second definitive proof. Although five other countries (Cambodia, Cuba, Laos, North Korea, and Vietnam) have remained faithful to communist principles, those countries were usually relegated to footnotes as actually existing, but quantitatively insignificant counterexamples. It is appropriate to treat the four Asian countries as China's satellites – which in fact they are. (Cuba is a special case.<sup>1</sup>)

Size matters: The Union of Soviet Socialist Republics (USSR) was, and the People's Republic of China (PRC) is a global superpower. Had the Soviet-type planned economy not been abandoned by the USSR and its allies in Eastern Europe, and the socialist world system remained a more or less credible alternative to the capitalist market economy, China, or even India and Brazil – i.e., the largest and politically strongest states of the “third world” – might not ever have opened their markets to Western multinational companies to the extent that they did. Thus, globalization would not have happened either – at least not with the same speed as it did happen.

It is well-known that the Chinese economic reforms arising from the dismal performance of the classical socialist model started earlier, in 1978. However, what matters for this paper is that the reforms continued after 1989. In 1978, the term “reform” referred merely to modernization, more specifically the “Four Modernizations Program” of Deng Xiaoping (Shi 1998, p. 5). In name at least, reform referred mainly to the reopening of the 1963 modernization program associated with then-Prime Minister Zhou Enlai. Very importantly, in the new interpretation, that program included – in fourth place – the Open-Door Policy, an effort to attract foreign capital. So, the language changed slowly, although Yu Guangyuan supposed that Deng might have used the term “market economy” as early as 1979.<sup>2</sup> The expression “market economy” began to appear in academic publications by the mid-1980s only (more cautious Chinese authors preferred to write about a “commodity economy”). In 1984, the official party line was, “We do not practice the market economy, which is completely regulated by the market”, a phraseology ambiguous enough to be used both by those who supported and those who opposed the market economy, to argue that their position was backed by the party (Yu 2005, p. 37).

Deng Xiaoping was one of the most complex and consequential politicians of the 20<sup>th</sup> century. He joined the Communist Party of China (CPC) when he was just 20 years old in 1924, fought with the communists against the Kuomintang and Japanese, and was already rewarded with a vice-premiership in 1952. His main allies were the reformer Zhou Enlai and Liu Shaoqi. Deng opposed including “Mao's thoughts” in the Chinese constitution;<sup>3</sup> after the failure of the Great Leap Forward, he, together with Zhou and Li, tried to rebuild the economic institutions destroyed by Mao. Unsurprisingly, at the start of the Cultural Revolution in 1966, he lost all

1 By 2020, only North Korea and to some extent Cuba are communist in the classical sense. If China before Xi was authoritarian capitalism that term also fits well in the cases of Cambodia, Laos and even more so Vietnam.

2 In an interview with the editor of *Encyclopaedia Britannica*, see Yu (2005).

3 Gao (2008) claims that Deng was never a Marxist, but rather a pragmatic Chinese patriot.

of his positions. After Mao died in 1976, Deng came back. He outsmarted his conservative enemies (the so-called Gang of Four) and by 1978 was China's *de facto* ruler.<sup>1</sup>

The post-1978 reforms were not merely a reincarnation of the Four Modernizations Program. Given China's cultural respect for tradition, Deng realized that he could not break with Mao like Khrushchev and Gorbachev had rejected Stalin. Hence, Deng's famous verdict on Mao's historical role: "He was 70% good and 30% bad". Whatever we know about him today, Deng was hardly a communist ideologue, like Mao or Stalin, who ruled their empires for nearly 30 years. His famous statement that "it does not matter if the cat is black or white so long as it catches mice", made the Chinese reform work. The only problem with that quotation is that Deng said it at a Communist Youth League conference in 1962; therefore, it was not meant for a moment to be interpreted as the CPC's attitude *after* 1989.<sup>2</sup> Few storytellers care about such bibliographic detail, however.

Deng was behind some critical changes in the political system. Already in 1982, China imposed term limits on high-level political positions (including the president and the Party's first secretary) and significant decentralization measures, which included more power for village and township governments and a substantial move towards some democracy at the local level (Oi 1999). The big test came in 1989. Deng had practically retired from day-to-day politics by then. His closest ally, Prime Minister Zhao Ziyang, was sympathetic to the student demonstrators and even tried to negotiate with them. The conservatives wanted to show force, but it was Dang who had to make the final choice. He opted for brutal force at Tiananmen Square. His "boss", Zhao, lost, was sacked and spent the rest of his life under house arrest. Deng did not stand behind him. Conservatives tried to use 1989's political crisis to undo the reforms and return to the Maoist model. It was only after Deng's *Southern Tour* in 1992 that the reform was back on track and it now was equated officially with the transformation of China into a "socialist market economy" (Shi 1998, p. 6).

From Kornai, we knew that it was doubtful from the very beginning whether such a hybrid system could be sustainable without turning the political system from a communist dictatorship into some form of legal-rational authority (if we may use a Weberian term here). Our interpretation is that China, for more than three decades after 1978 cautiously was building "capitalism from below"<sup>3</sup> - more and more capitalist and less and less just a hybrid political system. In 1983, the *rural system* of people's communes was replaced by townships (Oi 1999). The reforms allowed certain *free market forces* to operate. The two measures together unleashed an economy based on rural family farming. As communist cadres and the urban population increasingly became dissatisfied (Nee 1989), the reform was an attempt to pacify the local cadres by creating township and village enterprises (TVEs).<sup>4</sup> The policy then shifted

1 Although he kept the title of "deputy", Deng never was prime minister, president, or first secretary of the Party.

2 See Chambers Dictionary of Quotations (1993 p. 315), referenced in [https://en.wikiquote.org/wiki/Deng\\_Xiaoping](https://en.wikiquote.org/wiki/Deng_Xiaoping), last visited 7 February 2020.

3 For two slightly different interpretations of the term, see Eyal, Szelenyi and Townsley (1998) and Nee and Opper (2012).

4 Mostly a planned transitory process aimed towards market conforming, conventional firms. Since the mid-2000s, the Chinese government no longer provides statistical data for TVEs as a separate independent sector.

gradually, more forcefully after Deng's Southern Tour, to cities and industry. Nevertheless, in the early stages of the reform, when the private sector was still discriminated against, private firms often were classified as collectives. That term remains in use today. The Statistical Office classifies firms as follows: state-owned, collective, cooperative, joint and limited liability share companies, private firms, funded by Hong Kong, Macao and Taiwan, foreign companies, and self-employed units. No wonder that the statistical distinction between China's private and public sectors is blurred (Kolodko 2018; Nuti 2019).

Similar to the agrarian reforms in Hungary from the mid-1960s onwards, agricultural prices were deregulated gradually. Production quotas were lowered and later eliminated. The result was the closing of the gap between urban and rural incomes. The big winners were the peasants. When China began reforms in 1978, it was still primarily a rural, agrarian country. To some extent, the nation's extraordinary economic growth can be attributed to its inexhaustible labor supply.<sup>1</sup> Initially, the 1978 reforms may not have been much more than an attempt to moderate the Cultural Revolution's extremes and especially to solve the devastating, but recurrent food shortages.<sup>2</sup> That goal was reached by undertaking relatively minor adjustments, especially by shifting from agrarian communes to the household responsibility system.

Unlike many other countries (e.g., Russia or India), an ample "historical reservoir" of rural entrepreneurship is found in China. As Yasheng Huang (2008, pp. 57–62) has pointed out, entrepreneurship in China had deep rural roots, not only in agriculture. Whyte (2009) also emphasizes that China had had centuries of extensive commercial development and intensive agriculture. Instant familiarity with markets exists among ordinary villagers (see also Rawski 2007, p. 103). One has, of course, to be careful in ascribing entrepreneurial success to such a historical reservoir, that is, to China's cultural heritage. After all, since Max Weber, the received wisdom has been that Chinese culture in general, and Confucianism in particular, have been obstacles to modernization and entrepreneurship. But the rise of capitalism in East Asia and China's economic growth during the past three decades does not necessarily exclude the Weberian argument. After all, Weber was interested in the origins of capitalism, and why capitalism emerged in the West and not in the Orient. The question to be posed now is this: can the elements of traditional culture be reassembled to fit the requirements of modernity (Peng 2005, p. 345)? The answer many scholars gave to that question was "yes" (Vogel 1991, pp. 92–101; Peng 2005; Whyte 2009).

The next stage was creating isolated *free-trade zones* attracting mainly small-scale Chinese capital from Hong Kong and Taiwan. After 1985 and especially after 1989, the reform began to shift from the countryside to the cities. The creation of private property rights in state-owned enterprises happened much later, but even when the enterprise sector was privatized to a large extent, the word "privatization" was never used in official documents. Instead, Chinese authors preferred to speak about *cross-border mergers and acquisitions*, a terribly misleading euphemism (Chen and Young 2010). In retrospect, it is also important to underline that the concept of private property was not incorporated into the Chinese constitution until 2004.

1 Sachs (2005, p. 158). Labor reserves remain abundant. According to the World Bank, 18% of China's 2017 working population remained employed in agriculture.

2 In the 20<sup>th</sup> century alone, China has suffered six major famines, resulting in the loss of millions of lives.

## *The pendulum swings back*

As we know from *Freedom House* data and publications by Larry Diamond (2013, 2015, 2019) and others, the “third wave of democratization” (© Huntington) came to an end worldwide around 2005. Over the past 15 years, the democratization trend stopped and then reversed. The number of countries that became illiberal (“partially democratic”, “electoral authoritarian”, non-electoral authoritarian”, or “unfree”) in *Freedom House*’s terminology has expanded. China, however, was capable of keeping its positive international image until very recently (although it was ranked as “unfree by the Freedom House experts all along). Until 2020, the Chinese economy’s growth was stellar year after year. Chinese firms (though often state-owned enterprises) proved to be very successful in international markets, foreign direct investment (FDI) was pouring in and out of the economy on the order of hundreds of billion dollars annually, the names of Chinese billionaires filled the business columns of the world’s English-language newspapers, and so on.<sup>1</sup> Those sources duly reported examples of China’s income inequalities, notorious corruption cases, deteriorating environmental conditions, and the like, but all such negative features fitted reasonably well into the general characterization of an illiberal, capitalist system (Zakaria 1997). On that basis, many Western commentators (e.g., Sachs 2005) anticipated that it was only a matter of time before China’s economic success would turn the country into a liberal democracy.

The fact that Chairman Mao’s gigantic poster has been displayed all along at Tiananmen Square and his photo is reproduced on the Renminbi banknotes of *all* denominations has not bothered foreign analysts. Those analysts also were inclined to neglect the unambiguous first articles of *The Constitution Law of the People’s Republic of China* as well:

- “(1) The People’s Republic of China is a socialist state under the people’s democratic dictatorship led by the working class and based on the alliance of workers and peasants.
- “(2) The socialist system is the basic system of the People’s Republic of China. Sabotage of the socialist system by any organization or individual is prohibited.”

Until President Xi Jinping elevated himself to the top of the political hierarchy, one could argue convincingly that despite the governing party’s official name (Communist Party of China, or CPC) and its insistence on standing for the cause of socialism (“The Party’s highest ideal and ultimate goal is the realization of communism” – as the CPC’s 2017 Constitution states in its very first paragraph), it was not the same party that existed at the time of Mao Zedong. Daniel A. Bell (2008) suggested half-jokingly that the CPC might be renamed as the Confucian Party of China, and he certainly had a point. The CPC’s historical trend moved away from emphasizing Marxism-Leninism-Maoism, especially class struggles. Moreover, Deng Xiaoping did place a great deal of weight on one of the central values of *Confucianism*,

<sup>1</sup> The latest *Forbes* list of billionaires contains five Chinese entrepreneurs among the globe’s top 40, the richest being 48-year-old media magnate Ma Huateng, with USD 39 billion in assets ranking in 20<sup>th</sup> place. See <https://www.forbes.com/billionaires/list/#version:static>; last visited 28 January 2020.

namely meritocracy; in the Hu-Wen era<sup>1</sup> between 2003 and 2013, another Confucian idea, that of social harmony, was invoked rather often.<sup>2</sup> For the distant observer, the CPC at the beginning of the 21<sup>st</sup> century would have resembled more closely the Kuomintang of 1950 than the CPC of 1978. In the academic world and the Western media, the same ideas were translated as *Chinese pragmatism* (Roland 2019).

For many years, Janos Kornai's overall assessment was not very different from that of the Western academic mainstream. He admired many aspects of the reforms (e.g., sustained GDP growth, visibly fast technological modernization, the ending of the “one-child policy” in 2015,<sup>3</sup> and state-supported massive enrollment of Chinese students at world-class Western universities). Like others, as a fact of reality, he accepted the Communist Party's monopoly, too (Farkas 2016). On one occasion, he used the term “quasi-communist party”, the members of which were allowed to participate in corrupt local businesses, including the so-called *princelings* (children of high-ranked cadres), who in that unique way have created their own stakes in the Chinese economy's transformation.<sup>4</sup> The predominant role of the CPC is *not* a very high price to pay to avoid a civil war, he asserted at that time. Furthermore, Kornai was pleased to acknowledge that, relative to Mao's time, even the dictatorship's brutality had softened considerably. In a 2014 paper published in Hungarian only, he still saw a “50-50” chance for “democratization of political institutions”, as opposed to the possibility of ruthless and naked repression. There, Kornai turned the customary argument in the opposite direction. The slowdown of Chinese GDP growth – which coincided with the aftermath of the 2008 international financial crisis – can lead to aggressive pro-growth government policies, to an increase in investment, and to cuts in wages and welfare spending. If that was the direction in which things would go, Kornai warned, tensions and protests could be met by more forceful retaliation, the country's leaders might set out to incite nationalism or even try a foreign military adventure. But there was an equal amount of chance for a good outcome – continued democratization, welfare reforms and the curtailment of corruption.

### *Kornai's U-turn*

As discussed above, China was and continues to be frequently seen as a capitalist country that entered the market reform trajectory very early on. Whether that perception is correct depends on what we mean by reform and how we evaluate how far away China has moved from the *classical system* of socialism (Kornai 1992).

1 The phrase is named after the Party's General Secretary and President Hu Jintao and Government Premier Wen Jiabao, who were considered to represent the fourth generation of Chinese leaders. They were viewed, at least ostensibly, as more reform-oriented and more open-minded than the leaders of the third generation. In Chinese ideological publications, the two's dominant political slogan was called the Scientific Development Concept.

2 Along the same lines, Kolodko (2018) characterized China as a “hybrid system in the form of socialist capitalism or ... capitalist socialism ... , a sort of *Chinism*”.

3 Actually, the “one child policy” was introduced in 1979 at the early stages of the Deng reforms.

4 At one time, 28% of the members of the Politburo were *princelings* (Li 2009b).

To the surprise of many foreign observers, the consolidation of power in the hands of General Secretary and President XI Jinping (often described since 2013 as China's "paramount leader" and "core leader" from 2016, and often called "Father Xi" in the party controlled press) has led to a gradual rebuilding of a communist political system – not seen since the death of Mao in 1976. As of 2020, we observe more and more signs of Xi accumulating power in his own hands, of a developing personality cult and of the "selective criminalization" of his political opponents, clothed in the ideologically more acceptable garb of an anti-corruption campaign. In our interpretation, three things have been unfolding in parallel.

*Firstly*, Xi has consciously and determinedly been pushing the country towards a one-man dictatorship justified by the ideological legacies of Mao and Deng.<sup>1</sup> In October 2017, the party's National Congress called for a constitutional amendment to repeal term limits and other important safeguards adopted in 1982. Unsurprisingly, all of the proposed changes were built into the Constitution in March 2018. By repealing the presidential term limit, that constitutional amendment has made it possible for Xi Jinping to remain China's supreme leader as long as he so desires.

*Secondly*, given the importance of China's emergence as a global superpower, the outside world gets more and more detailed information about controversial issues that already were known, but few outsiders care about their details and implications.<sup>2</sup> The *hukou* system is a good example. People who were born in the countryside and who now live in Beijing and other major cities are treated as second-class citizens. Several hundred million rural Chinese who are urban guest workers do not even get basic government provisions for their livelihoods because of how the *hukou* system ties them to their places of permanent residence, although in sectors and locations where labor shortages are endemic, the implementation of *hukou* rules became less severe.<sup>3</sup>

*Thirdly*, new facts emerge that were almost entirely hidden behind the veil of secrecy. Since 2017, for example, numerous reports have appeared about ethnic Muslim members of the Uyghur and Kazakh communities in the eastern part of the country, who were detained in extrajudicial "re-education camps". Estimates from 2018 placed the number of detainees in the hundreds of thousands. China continues to follow very oppressive policies against Tibet, too. In other words, Xi tries to transform a multi-ethnic, multi-lingual China into an

<sup>1</sup> Deng's name is mentioned explicitly in the Preamble of the Constitution together with Marxism-Leninism, Mao and Xi. That mention is intriguing since Deng was not a Maoist. But Xi must pay respect to Deng in the same way he had to acknowledge Mao's historical importance. In the Confucian Chinese culture, you *must* show respect to your predecessors irrespective of your personal opinion or the facts.

<sup>2</sup> *The Economist*, for instance, has extended its coverage of China significantly. In every issue, readers find a China section containing two or three well-researched articles. The same holds true for daily issues of the *New York Times*.

<sup>3</sup> Although the origins of China's *hukou* system date back to ancient times, the system in its current form came into being in 1958. A similar registration system was known in the USSR from 1932 until the fall of communism. In present times, an analogous household registration system exists within the public administration structures of Japan (*koseki*), Vietnam (*hộ khẩu*) and North Korea (*hoju*). South Korea's *hoju* system was abolished only in 2008.

ethnically, linguistically homogeneous nation-state.<sup>1</sup> Another frightening new development is the so-called Social Credit System, *de facto* a blacklist. By the end of 2020, it is intended to standardize and centralize administrative assessments of citizens' and businesses' economic and social reputations. The social credit initiative calls for the establishment of a unified record system for individuals, businesses, and the public sector, to be tracked and evaluated for political trustworthiness.

A few weeks before the above-mentioned constitutional reform, Kornai (2018) gave a speech devoted partly to China at a two-day Budapest conference organized to celebrate his 90th birthday in February 2018. China is not going in the right direction; the dictatorial features of the system become stronger and stronger, he stated. Speaking about the risks emerging from the country's lasting dynamic growth, the sheer size of the Chinese economy, and the erosion of multilateral cooperation, he said the following.

*"The official Chinese ideology is very much influenced by nationalistic ideas. Now, if China were the only nationalist power in the world, then one can think about isolation. But that is not the case. There are other giants, which are also nationalists. There is the USA, where the President is announcing 'America first'. Not the globe first, not the international community, not the future of the international community first, but America first. And then we have Russia, where the leadership again is explicitly and emphatically nationalistic (Kornai 2018, p. 62)".*

After alarming his Hungarian audience, Kornai (2019a) shocked the international community 14 months later in the form of a *Financial Times* op-ed on 11 July 2019.<sup>2</sup> The two main messages of that short article were built into its title ("Economists share blame for China's 'monstrous' turn") and its sub-title ("Western intellectuals must now seek to contain Beijing"). Kornai's words were unusually harsh, self-critical and normative. He recalled his own personal direct contribution to Chinese economic reforms and the fact that he (and others, of course) helped the Chinese communist leadership to gain worldwide sympathy among leading politicians and intellectuals for the economic successes, while they all closed their eyes to China's serious curtailment of human rights. Kornai wrote, "We, Western intellectuals dealing with China, are – perhaps with a few exceptions - the Frankensteins of our time. Many of us already bear moral responsibility for not protesting against the resurrection of the monster. And there are those whose responsibility goes much further, because they have taken on an active role as advisors. I include myself here." In an unusual gesture, Kornai directed advice to policy-makers and public intellectuals worldwide and made a historical reference to the beginning of the Cold War: "Decades ago, in the context of the threatening US-Soviet confrontations, a high-ranking American diplomat, George Kennan (1947) summarized what should be done

1 The relationship between communism and nationalism is very complicated. In the 19<sup>th</sup> century, communism was as internationalist ideology. In 1924, Stalin declared the principle of "socialism in one country" and his system took a nationalist turn, but it still retained an internationalist mission. Soviet involvement in Africa or Latin America was, in part, a Russian imperial project, but, in part, it also was driven by the dream of turning the world communist. Ethno-nationalistic movements in countries like Yugoslavia or Czechoslovakia were kept under strict control. A sharp difference exists between Stalin and Putin in this respect. Putin follows the Russian imperial project. While Mao also kept the "empire together", Xi has worldwide imperialist ambitions. Donald Trump's aim is to "make America great again". Putin and Xi likewise want to make Russia and China "great again".

2 Kornai's piece was translated into Chinese in July by a Hong Kong newspaper and into Vietnamese. An influential multi-lingual Chinese newspaper gave an extensive summary of the FT's essay (Street 2019). The latter one, to the best of our knowledge, was disseminated only on the Internet.

with the expression ‘containment’. Thus far and no further! Or more precisely: no further in this direction! What has happened already cannot be undone. But here we must stop, and we must take far more care to avoid carrying on in the role of Frankenstein.”

This short piece in *The Financial Times* (and its Hungarian translation) generated echoes both in Hungary and abroad that, in turn, motivated Kornai to write a longer and more detailed exposition of his views.<sup>1</sup>

Since the publication of the FT’s article, the situation has changed profoundly. In the September 2019 issue of *Foreign Affairs*, the leading US magazine for analysis of and debate about foreign policy, five lengthy papers were devoted to the assessment of President Xi’s policies and the risks emanating from them. One of those papers (Westad 2019) was built entirely on the relevance of Kennan’s 1947 paper, exactly aligning with Kornai’s arguments summarized above. That alignment was, of course, partly, but not entirely, coincidental. It seems that foreign policy analysts grasped the significance of the recent shifts in China more quickly than mainstream economists did. Seven months later, George Soros (2020) alarmed the European Union. He published an op-ed (under the telling title “Europe Must Recognize China for What It Is”) containing words very similar to those written by Kornai: “Neither the European public nor European political and business leaders fully understand the threat presented by Xi Jinping’s China.”

Let us summarize our analysis thus far. Ever since General Secretary of the CPC, Xi Jinping, became president, China had been turning more and more toward authoritarianism. Since 2013, Xi has been ruling like a dictator, and one could even begin to wonder if it really is a capitalist economy, or if it rather is what the CPC’s constitution claims the country to be: a “socialist market economy” with Chinese characteristics. Moreover, it is noteworthy that the official Chinese document released after Xi was elected to the presidency by the 13th National People’s Congress did not mention the word “market” at all (Xinhua 2018). When a report published by the state-owned news agency summarized the essence of “Xi Jinping[‘s] Thought on Socialism with Chinese Characteristics for a New Era”, a long phrase that had been added to the country’s amended constitution, eight fundamental issues and 14 fundamental principles were listed. In the two-page-long text, the word “socialism” appears seven times, but the words “market”, “ownership”, or “property” were not even mentioned on a single occasion.<sup>2</sup>

### *How to delineate capitalist and socialist systems?*

One of the authors of the present paper, Ivan Szelenyi, in a 2010 essay, reviewed the literature originating from China and claimed that China is “market socialism”. While, like Kornai he also perceived China to be on its way from communism to capitalism, he drew attention to

1 The two opinion pieces were re-published in an integrated form in the English-language academic quarterly *Acta Oeconomica*, published under the editorial control of János Kornai (Kornai 2019b).

2 As long as the official Chinese documents do not embrace the term “market economy” without reservation, Beijing cannot convincingly protest the legal treatment of the country by the World Trade Organization (WTO), in which China has been a member since 2001, but not recognized as a “market economy”. Without a WTO ruling in Beijing’s favour, the EU and the United States can keep imposing duties on cheap imports from China while disregarding its claim that they are priced correctly.

the literature on “market socialism” thesis and advised Western scholars to be attentive to the socialist features of post-reform China, proposing that China – straddling communism and capitalism – could be seen as a hybrid economy. However, in a more recent contribution (Szelenyi and Mihályi 2020b), we changed our minds because we saw China reverting increasingly to *communist dictatorial* policies.<sup>1</sup>

Kornai, in one of his recent, extensive writings, made an instructive distinction between the *primary and secondary characteristics of economic systems*. We adopt those two categories without modification and then supplement them with a third list of additional characteristics.

So, according to Kornai (2016), the three primary characteristics of socialist systems are the:

- (1) political monopoly of a one-party state that legitimates itself with the ideology of Marxism-Leninism.
- (2) means of production controlled exclusively by public ownership.
- (3) dominant form of coordination is bureaucratic, rather than market based.

Until 1989, that three-dimensional definition was sufficient. But the world is messy and keeps on changing. No one can say, in 2020, that China meets *all* three criteria fully (see Block A in Table 1), or stating the opposite, that *none* of the three criteria has any relevance because China switched to the capitalist model. No doubt exists, however, that China does have widespread private ownership and several building blocks of a market economy. Nevertheless, China and her Asian satellite countries are functioning under the control of one-party systems, the ruling parties legitimate themselves in Marxist-Leninist terms, the scope of private property is limited in many ways, and the statist sector of the economy – especially in finance – still play critical roles.

Our opinion is based partly on Chinese sources. While China specialists, like Philip Huang (2012), on the far left, Yasheng Huang (2008) on the classical liberal side, and Fan *et al.* (2019) more recently see China as an integrated market, they all doubt that private property became dominant; hence, for them, the economy is *not* capitalist. Huang estimates that by the end of the first decade of the 21<sup>st</sup> century, 70% of non-agrarian products still were being produced by the state sector, while the IMF put the same figure at just 30%. Nevertheless, both Philip Huang and Yasheng Huang agree that the interactions between publicly owned firms are market regulated. Yasheng Huang claims that enterprise privatizations mainly took the form of various state-owned banks and corporations buying up the shares of publicly owned firms that had been put on the stock exchange. In the enterprise sector, individual private ownership exists, but it remains of secondary importance. Philip Huang (2012) also claims that the overwhelming majority of the 50 or so Chinese multinational corporations listed in the *Forbes 500* were, in fact, state-owned. If that number is correct, then China created something like what a Hungarian reform-economist, Márton Tardos (1975), called a “network of holding companies” nearly a half-century ago.

<sup>1</sup> Throughout the present section – and in Table 1 particularly - we make a clear distinction between illiberal systems and dictatorships on the basis of social and economic considerations, but we are aware that Freedom House and many political scientists (e.g., Bieber *et al.* 2018) define illiberalism as a hybrid of democracy and dictatorship.

Table 1: The main characteristics of the Chinese society and economy, as of 2020

## Block A: Primary characteristics\*

Similar to capitalist systems		Similar to socialist systems		
1	The ruling political group ensures the dominance of private property and market coordination.	No	Yes	The ruling political group (the Communist Party) enforces the dominance of public ownership and bureaucratic coordination.
2	Dominant form of property: private ownership.	Partly	Partly	Dominant form of property: state ownership.
3	Dominant form of coordination mechanism: market coordination.	Partly	Partly	Dominant form of coordination mechanism: bureaucratic coordination.

## Block B: Secondary characteristics\*

Similar to capitalist systems		Similar to socialist systems		
4	Surplus economy. The buyers' market is the dominant state of the market for goods and services.	Yes	No	Shortage economy. The sellers' market is the dominant state of the market for goods and services.
5	Labor surplus is the dominant state of the labor market.	Yes	No	Labor shortage is the dominant state of the labor market.
6	Fast technical progress; the system often generates revolutionary innovations.	Partly	Partly	Slow technical progress, the system rarely generates revolutionary innovation.
7	High income inequality.	Yes	No	Low income inequality.
8	Hard budget constraint for organizations in a quite broad sphere.	Yes	Yes	Soft budget constraint for organizations in a quite broad sphere.
9	Direction of corruption: It is mostly the seller who bribes the buyer.	Yes	No	Direction of corruption: it is mostly the buyer who bribes the seller.

## Block C: Further characteristics\*\*

## Similar to capitalist systems

## Similar to socialist systems

10	Liberal state. Multi-party elections matter, checks and balances, and free media.	No	Yes	Homogenous party-state structure, no free and fair multi-party elections. Media censorship.
11	The power of prime ministers and presidents is limited by rules and competitions.	No	Yes	One-man rule. Cult of personality.
12	Secure property rights.	No	Yes	Patrimonial property rights, selective criminalization of oligarchs.
13	Political parties are not allowed at workplaces.	No	Yes	The communist party is present in all workplaces (including the private sector).
14	Individualist culture.	No	Yes	Collectivist culture.
15	Fluctuations of the investment rate (business cycle)	No	Yes	The share of investments is very high in GDP.
16	Free movement of labor (including migration).	No	Yes	Limited freedom of migration (even within the country).
17	Full convertibility of the currency.	No	Yes	Limited convertibility.
18	Liberalized foreign trade, strong export orientation.	Yes	No	Closed economy, autarchy.
19	Predominantly liberalized land market.	No	Yes	All forms of land are in public ownership.
20	Foreign policy may or may not be a priority.	No	Yes	Ideology-based foreign policy is a top priority.

Sources: \* Based on Kornai (1992, 2016), \*\* Authors' own compilation.

We believe that at least three reasons can be found for explaining why arguments that China is socialist should be considered seriously.

- (a) China has been slow to recognize private property rights, and it often is doubtful whether what is being called private property actually is private.
- (b) The Chinese state is involved so intimately in economic processes that it arguably is beyond the roles usually assigned to a “developmental state”, even in its East Asian variant; and
- (c) The most obvious reason: China is a one-party state wherein communist ideology (even if the emphasis increasingly is on nationalism) legitimates the party.

Let us consider the three arguments in the framework of Table 1's 20 strong assertions. As Martin Whyte (2009) and Huang (2008, p. 31) pointed out more than 10 years ago, secure *property rights* usually are regarded as a major precondition for capitalism and dynamic

economic development, yet China has proven to be an outlier in that respect.<sup>1</sup> The national Property Law was passed only in 2007 (before 2007, various limits were imposed on the number of employees domestic firms could hire), and even that law was rather restricted in scope. As such, China diverged radically from Europe's post-communist countries, which, as far as property rights were concerned, followed the Washington Consensus cookbook rather closely. Most of those countries privatized early and fast; priority was assigned to creating identifiable owners, even if that meant transferring state property into the hands of former communist *nomenklatura*<sup>2</sup> (which happened especially in Russia) or to foreign multinationals (which happened especially in Eastern and Central Europe). China followed a dual-track approach: until the late 1990s, it rejected the privatization of large state-owned enterprises (SOEs), while allowing foreign capital into the country in the form of "greenfield" investments and permitting the launching of *de nouveaux* domestic private firms, albeit with some limits. It is very difficult to measure personal wealth accurately in China. Some billionaires may hide it. Others, like princelings (especially the family of President Xi) may oversee large companies that formally are SOEs but could be *de facto* private businesses owned by their princeling-managers.

The private ownership of agricultural land remains restricted or, to be more precise, banned constitutionally. Even though family farming was restored during the early 1980s, peasants did not receive titles to the lands they till. They lease land from the villages; the terms of the leases were gradually extended up to 30 years in 1984. Although leases had practically become indefinite by October 2008, no titles were granted to private individuals. As Nuti (2019) noted fittingly, the system works like the *arenada* system that spread during the USSR's New Economic Policy (NEP) of 1921-1926. Some commentators regard the October 2008 resolution of the party's Central Committee as a landmark event (Li 2009a) since it gave full rights to farmers to subcontract, lease, exchange, or swap their land-use rights.<sup>3</sup> Optimists expected that the resolution would enable retiring farmers to purchase homes in urban areas, that it would improve capital flows into rural areas, and – especially during the 2008 global financial crisis when China's exports dropped sharply – that it would increase domestic production and help China to change course from export-led industrialization to an economic growth path driven by domestic consumption. Li Cheng saw the new land reform as a step towards eliminating the *hukou* system, which had turned those who held rural *hukou* (especially migrant workers in cities with rural registration) into second- or third-class citizens. Land reform, it was hoped, might boost the income and consumption of former rural *hukou* registrants.

1 See also Oi and Walder (1999) on property rights issues.

2 The term *nomenklatura* (originally a value-free Russian word, borrowed from Latin, meaning a list of names) was used widely in the Soviet Union. In all former socialist countries (including China), it meant a category of people who held various key administrative positions in the bureaucracy, running all spheres of society: government, industry, agriculture, academia, and so on, whose positions were granted only with the approval of the country's Communist Party. Virtually all members of the *nomenklatura* belonged to the Communist Party. *Nomenklatura* is a concept similar to the western 'Establishment', holding or controlling both private and public powers (e.g., media, finance, trade, industry, state, and other institutions). In other words, *nomenklatura* is a broader concept than "elites". For the Chinese context, see Xu (2019).

3 A recent empirical study, however, reports that rural land rights confirmation had significant and positive effects on the likelihood and amount of transfer-out land at the 5% significance level, but the effect on transfer-in farmland was insignificant. See Xu *et al.* (2017).

Let us now refer to Block B in Table 1, the six *secondary* characteristics of idealized economic systems – i.e., capitalism versus socialism. As we have noted already above, the points included there are taken directly from Kornai (2016). Today, China certainly is not a shortage economy, and the direction of corruption is similar to that of market economies: it mostly is the seller who bribes the buyer (e.g., in the course of public procurement tenders). Surplus dominates the labor market, and income inequality is high. Thus, in those four key aspects, China displays market economy features. The question of hard or soft budget constraints (SBCs) is difficult: many examples of both can be found. SOEs and state-run banks enjoy the benefits of SBCs, and even genuine private companies are bailed out when subvention seems essential for one political reason or another (Nuti 2019). It is not easy to assess the pace of technological change, either. In many ways, Chinese firms are extremely efficient, but at the same time, it remains true that revolutionary innovations are few and far between. Nonetheless, at least one Chinese firm (Huawei) ranks at the top of the international innovation curve, and the present Covid-19 crisis provides chances for Beijing to come out first with an effective vaccine. The jury is out.

In Block C, we list 11 further characteristics. Here we touch on certain spheres that never were close to Kornai's research agenda (e.g., foreign trade, monetary policy and agriculture). We conclude that on 10 dimensions of the 11 dimensions listed, present-day China seems to resemble the well-known, classical socialist model closely. Looking at the dimensions of the analysis one by one, our judgments are not justified fully, but we believe that the overarching conclusion of Block C is convincing: China has kept many of the features of its pre-1989 version of communism.

Ever since 1989, Kornai never has changed his position on the political evaluation of the Chinese system. While he noted the gradual, but significant softening of the CPC's power monopoly, he never questioned that China is a dictatorship. Yes, it was, but it was shifting for a while towards a “non-electoral autocracy”, with term limits imposed on presidents, with significant powers allocated to the Politburo's rather diverse executives, and some liberal legislation at least for foreign investors (and some reasonably competitive elections at the local level). We also refer to a vague, nonetheless very forceful definition Mao Zedong gave to characterize his system: “politics in command”.<sup>1</sup> Obviously, for the Chinese leader back then the slogan meant the Marxist-Leninist interpretation of politics. Not all dictatorships are communist, but Mao's “politics in command” likewise is a good self-characterization of all other types of despotism. For example, in Russia, Iran, or the Gulf monarchies, different ideologies (ethno-nationalism, tribalism, Christian traditions, Islam or some combination of them) equally are suitable for legitimizing dictatorial regimes.

<sup>1</sup> In a widely publicized talk during the Cultural Revolution, when Mao and Lin Piao “reviewed 600,000 revolutionary students and teachers and Red Guards” marching at Tiananmen Square, the former gave the following instruction to his closest followers: “You should put politics in command, go to the masses and be one with them and carry on the great proletarian revolution even better....” See the *Peking Review*, Vol. 9. #47, Nov. 18, 1966. <https://www.marxists.org/subject/china/peking-review/1966/PR1966-47b.htm>, Last time visited: 29 January 2020.

### *How to delineate illiberalism from dictatorship?*

In our vocabulary, “illiberalism” and “dictatorships” have different meanings. Illiberalism is a project to create an authoritarian regime, with few limits on the executive branch, but in illiberal regimes, elections still take place, the judiciary still has some autonomy, and the media is somewhat free. None of those meanings really hold for China today. Questioning the logic of the Varieties of Capitalism (VoC) paradigm, as originally formulated by Hall and Soskice (2001), we see three different versions of capitalism: liberal states, illiberal states, and capitalist dictatorships. As we tried to argue throughout this paper, socialist systems currently take only one form: dictatorship. And that is the box into which – despite their different self-categorizations – the Kingdom of Cambodia, the Republic of Cuba, the Lao People’s Democratic Republic, the Democratic People’s Republic of Korea, and the Socialist Republic of Vietnam fit. The People’s Republic of China (PRC) increasingly fits, too, although between 1978 and 2013, the regime in Beijing drifted slightly toward a non-electoral autocracy. That drift altered substantially when President Xi took power. It may sound strange and controversial, but all in all, as of today, we must agree with the ideological self-labelling of the CPC: *China is socialism with Chinese characteristics.*

The classification of China is enormously important. Socialist countries are all dictatorships driven by Marxist-Leninist, one-party states and communist ideologies. If China is considered to be a capitalist dictatorship, then only a few unimportant countries like Cuba and North Korea would remain in the [what?] box. In other words, if our analysis is valid, then Fukuyama (1989) was entirely right: history has ended. On the other hand, if we accept that China (and its four Asian satellite partners + Cuba) are communist systems, then history has not ended in the way Fukuyama interpreted it.

Let us close our paper with a direct quote from Kornai’s seminal writing, when he first coined the supermarket metaphor, with which we started our present paper.

“History does not provide such supermarkets in which we can make our choice as we like. Every real economic system constitutes an organic whole. They may contain good and bad features, and more or less in fixed proportions. The choice of system lies only among various ‘package deals’. It is not possible to pick out from the different ‘packages’ the components we like and to exclude what we dislike. It seems to me that it is impossible to create a closed and consistent socioeconomic normative theory which would assert, without contradiction, a *politico-ethical value system* and would at the same time provide for the *efficiency of the economy.*” (Kornai 1980, pp. 156-157; our emphasis)

We agree with Kornai with one qualification. China was on its way to market capitalism with the possibility of eventually turning into a liberal democracy. The road was rocky, with many back-and-forths. But the shift to liberal democracy did not happen. The 1989 massacre at Tiananmen Square, approved by Deng, was a more alarming setback than contemporary Western observers realized. Today, we are much like Kornai, increasingly skeptical about what has been happening in China for the past eight years. Kornai did a U-turn in his theorizing about China, but what is more important, China seems to be taking a U-turn back to the pre-1978 epoch.

Table 2: Varieties of capitalism in comparison with the socialist systems in the 21<sup>st</sup> century

	Capitalist systems	Socialist systems
1	Liberal states: Elections matter.	x
	Liberal market economies (as little state intervention as possible) E.g., Australia, the Czech Republic, Hungary (until 2010), UK and USA	
	Coordinated market economies, conservative version (with targeted social policy interventions) E.g., Post-WWII Germany	
	Coordinated market economy (Social-democratic version) E.g. Scandinavian countries	
2	Illiberal democracies: Ethno-nationalist policies, but elections matter. E.g., Hungary (since 2010), India (under Modi), Japan, Poland (since 2015), Russia (under Yeltsin), Singapore, Taiwan, and Turkey	x
3	Dictatorship or non-electoral autocracies: Politics and ideology trump economic rationale + there are no elections, or they do not matter. E.g., China (1978-2012), Gulf monarchies, Iran, Russia (under Putin), several post-Soviet republics,	Dictatorship: Politics is in command + Elections do not matter. E.g., China (since 2012), Cuba, Laos, North Korea, and Vietnam.

Source: Authors' compilation.

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## 9. The Place of Rent-Seeking and Corruption in Varieties of Capitalism Models

### *Introduction*

The purpose of our contribution to this volume<sup>1</sup> – the fourth in a series of similar chapters<sup>2</sup> – is to renew the discussion of rents, which have been largely neglected by mainstream economists. In our search for a theoretically sound explanation of the phenomenon of “abnormal” or “extra” profits, as they are often labelled in current scholarly discussions, we have turned from Smith and Marx to Ricardo.<sup>3</sup> While the question of inequality was central to the economics of the 19<sup>th</sup> century, 20<sup>th</sup>-century economists tended to neglect issues of inequality in incomes and wealth. When this theme was brought back to the centre of attention, for instance by Simon Kuznets (1955), it was assumed that economic growth would automatically take care of it; as President Kennedy later famously said, “a rising tide lifts all boats”. During the past few years, this topic has received increasing attention, especially in the wake of Thomas Piketty’s unconventionally voluminous, but nevertheless hugely successful book *Capital in the Twenty-First Century* (first published in French in August of 2013).

According to Piketty, not only have inequalities increased since the 1970s, but capitalism itself has become unequal in a different way: more and more wealth is now inherited. Capitalism has become patrimonial. In a sense, the system is being re-feudalised before our eyes. Piketty is essentially right, but for the wrong reasons. We can accept his assertion – made in his book and in many other places – that inequalities have been growing for almost half a century, and we share his view that this is a major threat to the legitimacy of the liberal order at both the national and the international level.<sup>4</sup> We are, however, deeply sceptical about his central explanation, namely that an excessive growth of profits<sup>5</sup> is the fundamental reason for the present inequalities, which have slowed growth and generated popular dissatisfaction over a considerable period.

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1 This paper, in its final form was published in Gerőcs Tamás – Szanyi Miklós (eds.) [2019]: *Market Liberalism and Economic Patriotism in the Capitalist World-System*. Palgrave Macmillan: London – New York – Shanghai, pp. 67-97. The text in many places overlaps with the substance of Chapter 2 in the present volume, under the title „Two different sources of inequalities: profits and rents in advanced market economies”.

2 See Mihályi – Szelenyi (2016 a, b, 2017).

3 E.g. Summers (2016).

4 It is another – though not unimportant – matter that the epoch between 1910 and 1970, when measured inequalities fell, was far from ideal. This period was burdened with, *inter alia*, the Great Depression, two world wars, and the Iron Curtain.

5 In Mihályi – Szelenyi (2016b), we deal with interpretations of the adjective „excessive” at length. Piketty’s entire argument is based on his alleged discovery that  $r > g$ , where  $r$  is the average growth of profits and  $g$  represents the average growth of GDP/capita. We show that the  $r > g$  model is a statistical artefact arising from the intermingling of the concepts of profit and rent on the one hand, and capital and wealth on the other.

The rest of this chapter is structured as follows. In Section II, we will discuss capitalism in general (without any geographical limitations) in an attempt to bring economic analysis of the Ricardian concept of rent – something different from the category of profit – back into the mainstream. We will argue that this distinction is crucial to an understanding of the growth of inequality and its implications for various models of capitalism. Section III will be devoted entirely to a discussion of the role of rent and rent-seeking in post-communist capitalist countries. Our contribution to the existing literature is a delineation of three periods within the past 25 years. The three phases of rent-seeking are as follows:

- (i) market capture by political elites;
- (ii) state capture by oligarchs;
- (iii) autocratic rulers' capture of oligarchs by means of selective criminalisation and the redistribution of their wealth to loyal new rich.

Sections IV and V will summarise our main points and briefly discuss the most important social consequences of growing inequality, both in advanced capitalist countries and in the post-communist world.

### *Profits versus rents*

As is well-known, Karl Marx (1867) focused on profit-wage differentials in Volume I of *Capital*. In an attempt to elucidate the concept of exploitation, he proposed a model in which owners of capital were an ever-shrinking minority while a growing number of wage labourers received only the costs of the reproduction of their labour power. Piketty (2013) accepts Marx's conclusion that there is an overarching, secular tendency toward an infinite accumulation of capital, which is concentrated in fewer and fewer hands.

Marx wanted to show that property is not "theft" (Proudhon, 1840). He insisted that all market exchanges are exchanges of equivalents. It is not capitalists' personal greed that drives the institutions of exploitation and the extended capitalist reproduction process. Capitalists do pay the full price of their workers' labour power (hence the costs of the reproduction of their labour power), but they keep their employees working beyond the hours necessary to cover these costs and thus appropriate the surplus created during these extra hours of work. In a closed economy, under perfect competition, the individual capitalist has no choice. He has to keep wages at a level which reproduces labour power, and he needs the surplus (profit) to reinvest in order to remain competitive with other capitalists. The low wages of the working class and the profit of the capitalists, therefore, fit into an equilibrium model. As Keynes once said, the capitalists of the late 19<sup>th</sup> century "were allowed to call the best part of the cake theirs, and were theoretically free to consume it, on the tacit underlying condition that they consumed very little of it in practice"<sup>1</sup>. "In fact, it was precisely the *inequality* of the distribution of wealth which made possible those vast accumulations of fixed wealth"<sup>2</sup>. Hence, under these circumstances, the expanded reproduction process was a positive-sum game.

1 Keynes (1920, 1971) p.20.

2 *ibid.* pp. 18-19. Italics in original.

Marx thought in this way as well, although he obviously did not use this metaphor. If all profit has to be reinvested, more profit may mean more jobs (which Marx did *not* consider in the mid-19<sup>th</sup> century) and/or may mean higher wages for workers (a means of generating sufficient aggregate demand). John Roemer, arguably the most distinguished “rational choice neo-Marxist”, has noted correctly: “The neo-classical model of the competitive economy is not a bad place for Marxists to start their study of idealised capitalism”<sup>1</sup>. While Piketty expressly rejects Marx’s version of the *labour theory of value* and the *theory of exploitation* which follows from it, he tends to concur with Marx’s 20<sup>th</sup>-century followers in assuming that – apart from exceptional periods, when governments intervene into their economies with redistributive policies, or when wars destroy accumulated private wealth—wages remain relatively low all the time, while profits keep increasing. But why does the tendency towards unlimited capital accumulation and increasing inequality matter if capitalists keep reinvesting profits in the production process and thus create more jobs? If expanded reproduction is a positive-sum game for the economy as a whole, what is wrong with it? Marx’s original answer to this question – the theory of the declining rate of profit – sounded convincingly in this time but has proved to be wrong since then. Once we step out of Marx’s model, based on the labour theory of value, we cannot dispute that cheap technology, such as computers, can bring about massive productivity gains, and hence lead to increases in national income. This explains why profits did not decline, the world revolution did not happen, and workers’ real incomes have instead increased enormously since Marx’s time.<sup>2</sup>

David Ricardo (1817), who lived two generations before Marx, was convinced that the concept of rent was an indispensable explanation for the inequalities he observed. As is well known, he defined rent as scarcity rent<sup>3</sup>: an income derived from monopolistic ownership of agricultural land (and mines). He considered rent-seeking to be a negative-sum game. Rents create no new wealth; rather, they reduce economic growth and reallocate incomes from the bottom to the top.<sup>4</sup> This contrast between profits and rents is not at all trivial. Ricardo already noted the lack of clarity around this distinction: “[Rent] is often ... confounded with the interest and profit of capital”<sup>5</sup>.

While Piketty challenges the ethical bases of observable inequalities of income and wealth, he preserves the framework of the mainstream, neoclassical theory of income distribution which was originally developed by J.B. Clark (1899). Clark thought that wages and profits reflect the marginal product of labour and of capital, respectively. A person’s income is determined by his contribution to production – or, more precisely, by the marginal productivity of the

1 Roemer (1982) p. 196. Using another metaphor, this idealised capitalism is a win-win situation for workers and capitalists.

2 One qualification, however, is justified. Profit-maximising behaviour can reduce wealth at the national level. A classic example is outsourcing (especially in case of offshore investments of capital gains), which can cut wages and create unemployment at home, though it still creates wealth globally and tends to reduce global inequality.

3 In economic textbooks, this is often called „economic rent”.

4 As Ricardo put it, “The rise of rent is always the effect of the increasing wealth of the country, and of the difficulty of providing food for its augmented population. *It is a symptom, but it is never the cause of wealth*” (our emphasis). (*op. cit.* p. 40.)

5 Ricardo (1817, 2004), p. 34.

“factor of production” to which he contributes. It is truly a zero-sum game, with important consequences:

- (i) there is no “room” for rents in this model, or
- (ii) it must be assumed that rents are paid from net profits.

Piketty accepts both propositions, though he does not say so.<sup>1</sup> According to him, the neo-classical model is fundamentally right. When wage earners and capitalists fully share the annual national income between them, there is no injustice or exploitation; both classes get what they deserve.<sup>2</sup> Piketty’s line of argumentation allows for only one exception: the compensation of the highest-paid executives of multibillion-dollar corporations. He does note that these “super managers” receive more than they deserve, owing to their influence and power in the firms where they are employed. However, for Piketty, this is merely an undesirable, unnecessary, small distortion of the market economy.

### *Changing and new forms of rents*

Ricardo believed that agricultural land was lamentably scarce. Its supply is thus inelastic, while demand for food steadily grows. Under these circumstances, landowners receive scarcity rent without producing more or better food – i.e., without producing new value. Such rents channel resources away from “productive” investments and cut the real incomes of wage and salary earners. In part, Ricardo proved to be wrong, too. First, he did not consider how much the fertility of the land could be increased. Secondly, and more importantly, the price/value of agricultural land declined as the Americas and Australia were incorporated into the emerging capitalist world economy. In fact, there is an abundant supply of uncultivated agricultural land around the globe even in the 21<sup>st</sup> century.<sup>3</sup>

Pareto (1916)<sup>4</sup> and the American sociologist Aage Sørensen (2000) have already broadened Ricardo’s notion of rent to include all sorts of real estate and all kinds of monopolies. Stiglitz (2012) also points out that while scarcity rent does not really apply to agricultural land anymore, it certainly applies to residential property and other real estate. In some urban areas around the world, from London and Moscow to Shanghai and Singapore, tremendous wealth is generated merely from the scarcity of highly desirable locations. Today, the demand for housing no longer comes only from those people who live in a given city all the time, but also from the global wealthy who want to have houses in locations like the aforementioned

1 Another way of formulating our criticism is that Piketty (2013) conflates profits and rents and – as Weil (2015), Stiglitz (2015), and Atkinson (2015) have pointed out, among others – deliberately disregards the differences between capital and wealth. By contrast, Hodgson (2014) argues that the extended definition of capital – which includes cash, bonds, collateralizable assets such as buildings, and intellectual property – has analytical advantages as well.

2 Perhaps this was one of the reasons why his book was so well received in many mainstream macroeconomic departments.

3 According to the FAO’s definition, agricultural land covers only 33 % of the world’s landmass.

4 In *The Mind and Society*, Pareto made an interesting distinction between “speculators” (foxes) and “rentiers” (lions) – i.e., between those who seek profits and those who seek rents. A balanced market economy needs both foxes and lions; dynamism and innovation must be counterbalanced by stability.

globally attractive cities. Such privately held, consumption-oriented wealth becomes the property of a new urban “aristocracy” which passes these assets down from generation to generation. In the US, the total value of the housing stock was estimated at 26 trillion dollars in 2015, more than the value of all the shares traded on the American stock market.<sup>1</sup> This land-ownership structure, in which property is concentrated in the hands of the wealthy, is reminiscent of the privileged estates’ control of resources during the era of feudalism. Indeed, this concentration is especially intense in the top 1 % or even 0.1 % of the social hierarchy. However, we would hasten to add that there is a relatively large patrimonial upper-middle class – say the top 10-20 % – which also benefits from all this if they happen to inherit property in the aforementioned cities. Moreover, it is worth noting that there a self-reinforcing mechanism is at work here. As the example of London shows in the light of the Panama Papers, the influx of super-rich foreigners drives up property prices, which in turn significantly increases the short-run return on such investments.

But does such rent result only from land or real estate? When we speak of rent-seeking behaviour (as distinct from profit-maximising business investments), we use a broader notion of rent than was customary over the past 50 years.<sup>2</sup> Max Weber’s notion of closure can be a useful way to conceptualise rent in this broader way. He distinguished “open social relations”, where participation is not denied to anyone who wishes to join, from “closed relationships”, where the participation of certain persons is prohibited, limited, or subjected to conditions. According to Weber, closed groups manage to monopolise advantages by occupying scarce and desirable positions, or by making desirable goods and services scarce through clientelistic practices – i.e., the creation of cartels or monopolies.<sup>3</sup> Today, scarcity rent is one of the explanations for the very high compensation packages offered to the best specialists. Firms – along with universities, hospitals, sport clubs, etc. – compete with their peers for stars. They do not want to lose a legendary CEO<sup>4</sup>, professor, or athlete to a rival, as it could hurt their prestige and possibly their profits. They therefore pay more and more, especially in those countries where excessively progressive income taxes do not counterbalance such incentives. Closure in itself does not guarantee success at the firm level, nor for individual managers, but it is a great advantage *vis-à-vis* those who are excluded from competition.<sup>5</sup>

One of our contributions to the debate on rents is the – in our opinion, justified – introduction of the notion of solidarity rent. For example, membership in a trade union reduces wage differentials. While nationwide unions tend to fight for the highest level of employment, branch-based unions fight for the highest possible wages for *all* the workers in their branch.

1 *The Economist*, 20 August 2016. pp. 15-17.

2 See, e.g., Tullock (1967), Krueger (1974), Buchanan *et al.* (1980), and Bhagwati (1982).

3 See Weber (1920) (1978), pp. 43-44.

4 Solow (2014) calls supermanagers’ rent a „sort of adjunct to capital”.

5 On first glance, the Weberian concept of „closed” and „open” relationships looks identical to the proposition in Acemoglu and Robinson (2012), who coined the terms „exclusive” and „inclusive” societies. However, the two are not the same. The American authors – as the title of their book emphasises – analyse the growth process at the level of nations. Weber speaks of „closed” and „open” relationships within a given economy – and this is the right approach, if we are analysing inequalities within a given country. The same can be said about the dual concept of “open and limited access orders”, presented in North *et al.* (2012). Nevertheless, we strongly agree with their other assertion about the ubiquity of rent in every society, including the most advanced countries.

In particular, branch unions can push wages in their branches above prevailing market wages, and thus secure rent for their “members”. Through the highly sophisticated institution of collective bargaining, unions prevent the use of wage incentives which pay more to the best workers, teachers, or doctors – to the advantage of those who underperform. Arguably, the incomes of those whose jobs are protected by unions or professional associations are composed of two elements: wages or salaries, and rents. In developed democratic societies, one of the main functions of such institutions has been to create conditions for rents. When the power of trade unions was on the rise, solidarity rent helped to reduce inequality. However, in the context of the globalised world economy, their significance has declined<sup>1</sup>, and this in turn has likely contributed to the stagnation of real wages for low-skilled manual workers in the manufacturing sectors of many advanced economies, the US in particular.

Those who collect pensions in a pay-as-you-go system also receive solidarity rent, as do people who are on social welfare and those whose health insurance is paid by taxpayer contributions (as distinct from those who participate in a funded private-pension scheme, or whose healthcare benefits are paid by private insurance policies). Ideally, fiscal transfers always work as mechanisms of solidarity rent, as transfers from the rich to the poor. Even more so: given the logic of the demand side, solidarity rents can be economically beneficial since they can maintain or even boost consumption. This is a strong argument for unemployment benefits, but even conspicuous consumption can increase demand, create higher profits and wages, and hence contribute indirectly to wealth generation.

Aage Sørensen, to whom we have already referred, offered a broad interpretation of rent: “Rents are payments to assets that exceed the competitive price or the price sufficient to cover costs and therefore exceeding what is sufficient to bring about the employment of the asset. The existence of rent depends on the ability of the owner of the asset to control the supply”<sup>2</sup>. Sorensen also pointed out that the association of rents with land is not required: “Rent will emerge on all productive assets that are in fixed supply and that actors need to maximise their wealth”<sup>3</sup>. If we accept this framework, it follows that ownership of potentially rent-producing assets – such as licenses, credentials, and access to loans for starting one’s own business – is not restricted to capitalists. Those who do not own profit-generating capital still have the opportunity to accumulate wealth in other forms, such as pensions, as we have already mentioned.<sup>4</sup>

We have now arrived at the central definition of our study. We define rent as the difference between what income would have been in an “open relationship” and what it turns out to have been after the “closing” of such relationships to certain individuals or categories of individuals. In simple algebraic form:

1 Between 1980 and 2013, average trade-union density in OECD countries fell from 33 % to 17 %. This decline was uniform across all member countries, with the notable exception of the Scandinavian countries and Iceland. [https://stats.oecd.org/Index.aspx?DataSetCode=UN\\_DEN#](https://stats.oecd.org/Index.aspx?DataSetCode=UN_DEN#) accessed on July 10, 2015.

2 *op. cit.* p. 1536.

3 *op. cit.* p. 1537.

4 It is noteworthy that in The World Top Income Database, one of the bases of Piketty’s book, consumer durables and unfunded defined-benefit pensions are not taken into account.

Income from closed relationship – income from open relationship = rent

It may be difficult to measure all types of rents empirically, but their existence can be demonstrated by means of counterfactual reasoning. What would a closed group's income have been if its members had been competing in open relationships?

Within a well-defined historical-political epoch – say, one lasting 20-30 years, in which average people can make comparisons on their own – rents can be temporary or enduring. An entrepreneur who invents a new technology may collect rent for a while, but eventually his competitors will invest in the same (or a similar) technology, and his rent will disappear; the incomes of competing entrepreneurs will be set by the supply-and-demand mechanism. There are many spectacular examples of this: the success of Microsoft's Windows operating system; the rise of cell phones, which toppled copper-cable-based telephone companies from their privileged positions; and the shale revolution of the past decade, which has entirely reshaped the traditional OPEC-controlled oil industry. Following Sorensen (and also Marshall [1920]), we have identified three enduring sources of rent. First, some of the monopoly rents enjoyed by entrepreneurs are created *naturally*, since increasing returns to scale often make the costs of entering production within a given country prohibitive (e.g., network industries).<sup>1</sup> Governments may create rents by issuing concessions to open mines or licenses to run tobacco and liquor shops. Second, there are *personal* rents on biological endowments, such as individuals' genetic predispositions (e.g., special talents in popular sports or the arts). The third type is resource endowment at the level of firms and countries which exploit mineral wealth<sup>2</sup>, as well as other types of geographical advantages such as access to open sea, sunny beaches, or snowy mountains, etc.

This rent-based interpretation of the importance of the natural-resource sector can be further generalised. As the Hungarian economist János Kornai (2013) has argued convincingly, in other sectors (such as manufacturing or services), the most important markets are oligopolistic – perhaps even more so than in the natural-resource sector. The most efficient firms harness higher-than-average profits through arbitrarily large mark-ups – or, to use our terminology, they exploit a scarcity rent. This is not merely a theoretical possibility. A recent US study (Furman – Orszag, 2015) shows that the most profitable 10 % of firms have indeed pulled away sharply from the rest. Their return on capital invested has risen from more than 3 times that of the median firm in the 1990s to 8 times. This – as the cited study suggests – is way above any plausible cost of capital and likely to be pure rent.

This increasingly skewed distribution of profits (containing rents) could explain certain types of wage inequalities as well. When an industry includes only a few big companies, they don't have to compete with one another as hard to attract employees – and thus can end up paying their workers less than they would if there were true competition (labour-market monopsony). However, the opposite mechanism may work as well. Because of the rent-component hidden

1 In the context of globalisation, however, the number of companies is growing in every industry worldwide, and thus competition is actually increasing at the international level.

2 For many years, the World Bank has been regularly publishing country time-series under the label *Total natural resources rents (% of GDP)*, whereby rents are defined as the sum of oil rents, natural gas rents, coal rents (hard and soft), mineral rents, and forest rents. See <http://data.worldbank.org/indicator/NY.GDP.TOTL.RT.ZS>

in these firms' profits, they can afford to pay *all* or *some* of their employees more than the industrial average. There are usually two interrelated factors behind this: pioneering technology<sup>1</sup> and economies of scale arising from the concentration of firms within any given country. In fact, both of these factors play a crucial role in generating revolutionary (or Schumpeterian) innovation. While this generalisation may sound idiosyncratic for many economists trained on neoclassical equilibrium models, it is a commonplace in management-science literature that many important industries never have more than three significant competitors.<sup>2</sup> This same school of thought also claims that the shares of the three leading companies in many markets reach a ratio of approximately 4:2:1 – i.e., there is a significant market-share difference even among the top firms. Data from the US Census Bureau also supports this claim. In 2012, the top four US firms' average share of total revenue on a sector-by-sector basis was close to 50 % in the IT, telecommunications, and media sector, 40 % in retail trade, and almost 40 % in the finance-and-insurance sector.<sup>3</sup>

It is very important to underline that state-created monopolies or oligopolies are not necessarily evil, as they are often justified by other social objectives rather than social equity. For example, there are good and widely accepted reasons why the intellectual-property rights of pharmaceutical companies, individual innovators, and artists are defended by patents and copyrights – “closure” in the Weberian sense. It is not surprising that Aghion *et al.* (2015) found positive and significant correlations in the US between innovativeness and top-one-% income shares. Similarly, it makes a great deal of sense to require state permission for firms to build nuclear power stations, or even simple two-storey houses. It is also in the general interest that physicians have to acquire special occupational licenses (e.g., a university diploma) before they can start treating sick people. Other types of regulations (e.g., land-use bylaws in urban areas) can be assessed, if at all, only on a case-by-case basis.

### *Institutional consequences of rent*

Rents have at least three institutional consequences. Firstly, certain types and some levels of rent are necessary for social cohesion and innovation in society. Such rents may be seen as “deserved”, but on some level they are still “unearned”. The major legitimacy claim of market capitalism is meritocracy. At some point, the public will judge rents generated by any means to be “excessive” if those who receive them “do not work for them”. Most people accept that some rent is due to drug manufacturers and innovators, but there may be a cap on the amount that is seen as “reasonable,” after which point any further rent will be considered “exploitive”. The same is true for social benefits. In civilised societies, most people accept that the poor (or disabled) should have some social support (even if it is “unearned”), but at some point, it may be judged to be “too much”.

1 As we explained earlier, this is a temporary advantage.

2 This finding was first demonstrated by the founder of the Boston Consulting Group, Bruce Henderson (1976), then re-confirmed empirically by Reeves *et al.* (2012), using a much larger data set. Since then, successful companies like General Electric and others have lived according to this maxim. If they cannot be number one or two in an industry, they get out of that market and reinvest their resources elsewhere.

3 See *The Economist*, 26 March 2016.

Secondly, if individuals' wealth comes increasingly from rent rather than wages or profits earned day after day in a capitalist enterprise, there is little institutional incentive to reinvest such rent. The *nouveau riche* and heirs to fortunes are tempted to waste the rent they have collected – easy come, easy go. Profit-maximising entrepreneurs tend to invest their profits in optimal ways in order to fight off direct competitors. Rent collectors do not face competition; rent can be spent on “conspicuous consumption”. *Nouveau riche* entrepreneurs tend to use a chauffeur-driven Mercedes or private plane well before they can afford it. In a best-case scenario, second- and especially third-generation heirs will spend their inheritance on charity; in a worst-case scenario, on conspicuous consumption. The absence of institutional mechanisms that motivate owners of wealth to use it in efficient ways can have devastating social and economic consequences. It can lead to state failure and economic stagnation or even collapse.

Thirdly, and finally, in opposition to Piketty's main line of argumentation, we contend that voters and political activists are chiefly concerned about the *personal inequalities* of income around them. They are thus much less concerned about the concentration of economic wealth and power in the form of publicly traded shares or family-owned companies – i.e., the relevant wealth of capitalists in a class-based model. While it is true that sensational formulations – for instance, “48 % of the world's wealth is owned by 1 % of the world's population”<sup>1</sup> – can easily catch the attention of the media and, through the media, stick in the memory of social scientists (including Piketty, who often quotes such data), such “facts” do not tend to mobilise ordinary people. People tend to be agitated not because of gaps between businesspeople and wage-earners, but rather because of the large variations in employees' wages. Typical cases are when the salaries of doctors, teachers, or police officers are compared to the salaries of bank managers or celebrated athletes and musicians, or when minimum wages are compared to the minimum cost-of-living. This is one type of scarcity rent, as we explained above.

### *Class reproduction through the accumulation of human and cultural capital*

The educational system is an important terrain of Weberian closure. Given the high cost of education, especially of elite education, the most highly valued education is often inaccessible to youth whose parents cannot afford the often prohibitive costs.

This problem is particularly prevalent in the US. At Ivy League universities, youth from white upper-middle- and upper-class families are overrepresented despite efforts to support the children of less privileged families. One obvious mechanism is strictly achievement-based entrance exams, on which children from more affluent families simply outperform those from average families. It is less obvious, but US colleges' recent efforts to admit students not just based on measurable intelligence but also based on being “well-rounded” (i.e., having taken ballet classes, performed in plays, founded clubs, volunteered time helping handicapped

<sup>1</sup> The renowned charity Oxfam (2015) timed the publication of its fresh research for the opening of the Davos economic summit, thereby skilfully capturing headlines at many news outlets. Another sensational formulation of this same report was that the “85 richest people on the planet have the same wealth as the poorest 50 % (3.5 billion people)”.

children, etc.) works in the same direction as well. Whereas there is some randomness in the distribution of intelligence, these sorts of extra-curricular activities tend to be the domain of upper-middle-class, private-school-educated children<sup>1</sup>.

In sum, inheritance is another market-based institution that creates rent for its heirs. This can be inheritance of wealth (including valuable real estate) or social status linked to education at elite universities. This is what Bourdieu (1970) called “cultural capital”, as distinct from “human capital”. Cultural capital does more to reproduce the “patrimonial middle class” or “patrimonial upper class” than to increase the productivity of the graduate. It may cost parents as much as \$300,000 or \$400,000 to get their children an Ivy League BA or BSc, but that Ivy League degree will likely pass a kind of “noble” status on to their descendants. Employers do not necessarily seek Ivy League graduates because their technical skills are better, but also because hiring such people can add to the prestige of their institutions.

The experience of the United States – in many ways the pacesetter for the capitalist economic system – shows that family formation through assortative mating further strengthens these tendencies<sup>2</sup>. Since educated men tend to marry educated women more often than they did two generations ago, this inevitably leads to a concentration of income and wealth, which in turn helps these “privileged” parents invest time and money in their children’s futures, literally from the day they are born. Children born to families in which both parents (and especially grandparents) hold university degrees outcompete their less privileged peers up and down the educational ladder and later on the job market. This is the main institutional channel through which social inequalities are regenerated, and thus patrimonial capitalists are taking more and more ground—and not just the top 1 %, as Piketty suggests<sup>3</sup>, but the entire upper-middle class. Three successive cohort studies of 70,000 children born in the UK in 1946, 1958, and 1970 have shown that childhood circumstances – as determined by their parents’ social status – profoundly influence life expectancies and lifetime inequalities, despite all the welfare measures introduced by successive British governments since 1946.<sup>4</sup>

There is an additional mechanism of closure in the educational system, and that is credentialing. Education is often conceptualised in terms of human capital investment. It is usually assumed that human capital invested in education will lead to productivity gains and higher incomes. Nevertheless, powerful professional associations (such as the American Medical Association and the American Bar Association) can manipulate the supply of occupations under their jurisdiction by promoting licensing examinations, thereby driving up incomes for those occupations by adding a rent component to market-equivalent incomes from work.

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1 The authors are grateful to Daniel Treisman for this observation.

2 Greenwood *et al.* (2014).

3 *op. cit.* 485-486.

4 E.g., the meticulously collected data for the 1946 cohort suggest that women born in socially better-off families had a death rate about half that of everyone else born in 1946. Pearson (2016) pp. 301-302.

There is no need to list examples demonstrating that the term rent is used with different meanings not only in common parlance, but also in scholarly literature. In this section, we have tried to delineate the various types of rents and their characteristics. In the spirit of Ricardo, Weber, and Sorensen, we consider all incomes rents if they stem from ownership of *any* assets, where access to such assets is closed for other economic actors. Our present list comprises 9 forms of rent, but it is not exhaustive; depending on the institutional setup of a given country, additional categories could be included.

Table 1: Rents extracted in advanced market economies by firms and individuals

		TIME HORIZON		FAVORABLY MOSTLY FOR	
		Temporary	Enduring	Owners of for-profit firms	Ordinary individuals
	... without direct state involvement				
1	Innovative technology	x		x	
2	Positional goods and services (e.g. agricultural land*, real estate, honoraria of art and sport celebrities)		x	x	x
3	Natural monopolies based on economy of scale and scope (e.g. network industries, shopping malls)		x	x	
4	Limits to market entry by professional organizations (e.g. lawyers, doctors)**		x		x
5	Cartel agreements	x		x	
	... without direct state involvement				
6	Copyrights and other sorts of protection of intellectual properties (e.g. pharmaceutical industry)	x		x	x
7	Solidarity rent (e.g. collective bargaining, welfare payments)		x		x
8	Limits to market entry through licensing (e.g. medical profession)		x		x
9	State capture (e.g. discriminative law-making, tainted public procurements)	x		x	

Notes: \* First analysed by D. Ricardo. \*\* First analysed by A. Smith.

## *The Role of Rents in Post-Communist Capitalist Societies*

As we have argued in the preceding sections, there are robust indications that Western capitalism is becoming patrimonial capitalism. We are ready to accept this as a general hypothesis in the post-communist context as well, although it is still unclear whether the children of present-day oligarchs in Russia and China will be able to pass their property rights – including the rights to sell their assets to foreigners and to move their families' financial wealth to foreign countries – on to their children.<sup>1</sup>

As we argued above at length, rent-seeking behaviour has been present in all capitalist market economies, even in the most advanced ones. Centuries ago, high levels of inequality were driven by two forces: (i) in European countries (especially England), the privileged estate was able to convert its feudal privileges into privileged positions in the market; (ii) since appropriate mechanisms of market regulation were not in place, it was possible to create monopolies, or to create cartel-like agreements. A fitting example is the rise of the “robber barons” of the late 19<sup>th</sup> century in the United States (Josephson, 1934; Folsom, 2010). Some of these robber barons came close to “state capture” until the state’s elite fought back with anti-trust legislation<sup>2</sup>.

The transition from socialism to capitalism was often driven – or at least coloured – by similar and sometimes more extreme rent-seeking behaviour. During the transition from feudalism to capitalism, there was an intense struggle by old elites to retain their power by converting their formerly privileged positions into economic wealth. Those who suddenly converted from the idea of centrally planned economies to free markets did not always realise that some regulation and planning might be necessary to ensure genuinely free and competitive markets. Similarly, private-property rights were often, and remain, ambiguous. The conditions of law and order, and the separation of power – especially the separation of politics from the economy – were, and still are, in the process of negotiation. These conditions could not be implemented instantly after the disintegration of socialism. Even a quarter of a century after the transition, these conditions are still debated intensely in many countries. Post-communist capitalism is a curious system, where in many cases (Russia after 2000; Hungary after 2010; and Poland after 2015) “*politics remain in command*” to a large degree, even today. Ironically, Mao correctly defined the essence of socialism with precisely this formulation.

The institutional inertia of the transition was aggravated by a sense of general urgency to convert state property into private wealth as quickly as possible (although this has not been the case in China). In 1991, Boris Yeltsin set the goal of building capitalism in Russia in 500 days. During the early 1990s, political elites and their economic advisers believed that once they could identify owners for formerly state-owned firms, the free market would resolve all their other problems. They did not care about the rights of – or attempt to identify – the original private owners. If the first owner was incompetent or corrupt, market competition would

<sup>1</sup> We might add to this list the post-Soviet Central Asian republics, Belorussia, Ukraine, and Hungary – and since 2010, especially (but not exclusively) Romania, Bulgaria, Serbia, Albania, and Macedonia.

<sup>2</sup> Theodore Roosevelt’s anti-monopoly legislation of the early 1900s is a prime example of regulating rent-seeking.

replace him with a competent market actor. Given the specific circumstances, we shall distinguish *three different rent-seeking mechanisms*.

### *Market capture by political elites*

This phenomenon can be further broken down into three variants.

(a) *Old communist cadres' use of market mechanisms to turn state property into private wealth*

In the early stages of privatisation, it was often assumed that the former communist elite would convert its political capital into economic wealth.<sup>1</sup> In the eyes of many commentators, post-communist capitalism was simply a “kleptocracy” in which political bosses stole state assets. This undoubtedly occurred regularly in Russia<sup>2</sup>, Ukraine, the Central Asian republics, and – to a certain extent – Bulgaria and Romania, where the circulation of elites was minimal during the first few years. As Hankiss and Staniszkis have articulated, communist elites in Hungary and Poland quickly started trying to convert SOEs (state-owned enterprises) into private firms by using a technique called “spontaneous privatisation”<sup>3</sup>. However, these groups lost political power in 1989-1990.<sup>4</sup> As far as we can tell, communist political leaders in Hungary and Poland did not succeed in accumulating substantial wealth prior to 1989. Nevertheless, there is a kernel of truth to Hankiss' and Staniszkis' hypothesis. Some of the post-communist “new rich” in both countries began to accumulate capital before and during the transition, which became a starting point for the wealth they eventually amassed.

(b) *Market capture by new political elites during the privatisation of state property, either for personal enrichment or the recruitment of clients*

When mass privatisation became the official policy of these governments, SOEs were converted into private property by means of vouchers through sales at competitive auctions. Many workers, ordinary citizens, and their heirs did not know what to do with vouchers and thus sold them to risk-tolerant young investors under market conditions that changed daily. However, as we know from Polanyi (1944), markets do not materialise out of thin air; these markets were created and managed by states and political elites, and thus it was inevitable that domestic and foreign investors would confront market management.

1 This was the nomenclature-bourgeoisie hypothesis of Erzsébet Szalai (1989), Elemér Hankiss (1990), and Jadwiga Staniszkis (1991).

2 One good example is Victor Chernomyrdin. In the mid1990s, the CIA estimated his net worth at \$5 billion, though he claimed to possess only a few million. In 1978, he was already working at the Central Committee of the Communist Party; he later went back and forth between high government posts (deputy minister, minister of the gas industry) and major managerial positions (chairman of Gazprom). He was Prime Minister of Russia between 1991-1998. He passed away in 2010, taking his secrets to his grave. See Szelenyi 2010.

3 Voszka (1993).

4 For an excellent comparison of Central European post-communist capitalisms, see Bohle Dorothee and Bela Greskovits (2012). However, it is important to underscore that none of the Central Europeans included on the Forbes billionaires list are known to have been high-ranking officials of the communist party prior to 1989; see Szelenyi (2010).

During the communist era, private ownership was outlawed, and thus the accumulation of private capital was very limited. For domestic investors to be able to purchase state property, it had to be underpriced. Domestic investors without reliable track records or credit ratings needed government-guaranteed loans. This resulted in the preselection of the investors who could make bids at these auctions; being preselected was inevitably a consequence of personal or political capital. In countries where communist elites survived (like China), or where the new elites monopolised political positions (like Russia, Bulgaria or Romania), former (or in China, still active) communist cadres had specific advantages.

China is a special case, since its market transition took place under the rule of the Communist Party. According to the Forbes and Hurun lists of Chinese billionaires (see Szelenyi, 2010) during the first two decades of reform, wealth accumulation was driven mainly “from below”. As of the year 2000, virtually all Chinese billionaires had come from humble backgrounds, having begun their careers as rice farmers or bricklayers. Privatisation of large SOEs started around 1997, and there is some evidence that over the past decade or so, some high-level communist cadres and their families have become super-rich.<sup>1</sup> In Russia, Boris Berezovsky and Roman Abramovich are prime examples of people who have acquired substantial wealth mainly due to their *contemporary* personal relationships, rather than *previous* political connections.<sup>2</sup>

However, in giving these “grants” to the new grand bourgeoisie they had appointed, political bosses also anticipated certain kinds of returns. In exchange for Yeltsin’s contribution to his advancement as a businessman, Berezovsky supported Yeltsin’s 1996 re-election campaign, and when a Communist Party candidate came to represent a real threat to Yeltsin’s prospects, Berezovsky also managed to persuade six other oligarchs – the so-called Big Seven, the wealthiest of the wealthy at that time – to support the President. In addition to Berezovsky, the members of the Big Seven included Mikhail Fridman, Vladimir Vinogradov, Mikhail Khodorkovsky, Vladimir Gusinsky, Vladimir Potanin, and Aleksander Smolensky. In 1996,

1 There are contradictory assessments of the personal wealth of former Prime Minister Wen Jiabao and current President Xi Jinping. The New York Times reported that the net worth of each man’s family may be in the range of \$1-2 billion dollars. If there is wealth in the Xi family, most of it was made by the President’s daughter, Qi Qiaoqiao, and her husband Deng Jiagui. It is also rumoured that many large, nominally state-owned firms are led by CEOs who are “princelings”, the children of former “revolutionary heroes (President Xi is one such example). Thus in reality, these firms are entirely privately owned (Lu Peng, personal communication).

2 Boris Berezovsky (1946-2013) was one of the first and the most prominent founding member of the club of newly emergent oligarchs. In 1983, Berezovsky earned a Ph.D. in mathematics and became the director of one of the laboratories at the Institute of Management of the Soviet Academy of Sciences. There is no definitive indication that Berezovsky was close to high-ranking Soviet party officials. He had good relationship with the young reformers Yegor Gaidar, Anatoly Chubais, and Valentin Yumashev. Yumashev was a journalist who eventually became Yeltsin’s chief of staff and the second husband of Tanya (or Tatyana) Yeltsin. However, in the early 1990s, Yumashev was only a ghostwriter for the President. He helped Yeltsin write his 1989 book and helped him with “Notes of a President,” published in 1994. It was Yumashev who introduced Berezovsky to Tatyana, who at that time was married to Dyachenko, a commodity trader who later became Berezovsky’s business partner at Sibneft. With his newly acquired contacts, Berezovsky managed to take major managerial positions at – and eventually ownership in – the car-manufacturing firm Avtovaz, the Russian national airline Aeroflot, and the major oil company Sibneft.

only five years after the collapse of the USSR, the Big Seven claimed that they owned half of Russia.<sup>1</sup>

(c) *Manipulating markets after privatisation for personal enrichment or the recruitment of clients*

The suspicion that political officeholders might use their offices for personal enrichment is still a serious concern. Bálint Magyar (2016), a trained sociologist and a former minister in the Hungarian Socialist-Liberal governing coalition of the 1990s and early 2000s, has characterised Hungary's post-2010, right-wing Fidesz government as a "Mafia state". In his model, Prime Minister Viktor Orbán plays the role of a "godfather". Some scholars assert that government contracts and EU-subsidised programs are allocated to loyal clients, including family members and members of Orbán's "adopted family".

Arguably, one of the most important mechanisms is the manipulation of public procurements, which, by law, require open competition. Some sectors are particularly susceptible to such manipulation (e.g., road construction, IT services, commercial advertising paid for by SOEs). By governmental decree, such purchases can be declared to be "emergent", which bypasses complicated competition requirements and gives contracts to clients who are occasionally proxies for government officials. Without competitive bidders, or with reduced numbers of bidders, prices for the services the government contracts can be way above what they would have been in free competition; thus the winners of such bids collect substantial rents over the profits they would have made on real markets.<sup>2</sup> The government can also place limits on the licenses it issues to popular radio stations or television channels, for instance.

As the Yeltsin example illustrates, electoral campaigns need funding from wealthy supporters who finance the campaign directly and indirectly through the media. Such deals could be a source of personal income for political bosses such as President Putin in Russia<sup>3</sup> or Prime Minister Orbán in Hungary. The allocation of tobacco-shop licenses in Hungary was an easy way to reward a significant number of supporters. Prior to this, virtually all Hungarian stores (including grocery stores and gas stations) were allowed to sell tobacco, and a substantial part of their income came from this trade. In 2013, the government created special stores with the exclusive right to sell tobacco, thus transferring "rent" from other stores to the newly licensed tobacco stores. This was not a major source of income; nevertheless, it created a 20-year monopoly for thousands of small shop-keepers, who, according to opposition politicians, were loyal supporters of the government.

1 The Big Seven – Russia's Financial Empires, [www.worldbank.org/html/prddr/trans/feb98/bigseven.htm](http://www.worldbank.org/html/prddr/trans/feb98/bigseven.htm)

2 For an empirical study of the situation in Romania, see Pirvu (2015).

3 Vladimir Putin's personal wealth is the subject of wild speculation. Some commentators claim he is the wealthiest man in the world, with a personal net worth of \$40-\$70 billion. Putin's official disclosures suggest that he owns two apartments and one spot at a garage, worth a total of \$119,000. There are also similarly wild and unconfirmed conjectures about the private wealth of Hungary's Prime Minister, Viktor Orbán. The personal wealth of current political office-holders may be overestimated by political opponents. In any case, smart political bosses do not accumulate wealth in their own names but rather pass it on to their extended family and friends. Thus, if Putin has indeed managed to accumulate wealth of his own, it may be under the name of his daughter Yekaterina and her husband; it has been reported that the couple holds a 2.83-billion-dollar share of the Silberg Company. Putin's friend, the cellist Sergei Roldugin, is also believed to have acted as his surrogate; Roldugin has reportedly moved billions of dollars into Panama.

Of course, such manipulation of markets is well known in all countries (famous examples include public purchases of military equipment in the United States). However, as discussed above, these practices are especially widespread in post-communist economies. This is not only our opinion; it is one of the main reasons why Transparency International has labelled these countries “corrupt”. Ironically, the harm done in this way by EU money, which was meant to help the new (post-communist) member-states has outweighed the progress emanating from newly devised transparency mechanisms, which were conditions of EU membership.

(d) *State capture by oligarchs*

State capture by business elites is most often seen as a manifestation of rent-seeking and corruption in non-post-communist emergent markets, such North America in the late 19<sup>th</sup> century or Africa in the 20<sup>th</sup> and 21<sup>st</sup> centuries. Such rent-seeking behaviour exists in post-communist nations, but it is relatively rare, given the weakness of the propertied bourgeoisie there and its dependence on political elites. As we have already mentioned, those who managed to capture the state in the United States in the late 19<sup>th</sup> century were called “robber barons”, prime examples of which include Rockefeller, Vanderbilt, and Gould. In the post-communist world, powerful figures such as these are generally referred to as oligarchs.

The use of the term oligarchs is disputed. In this paper, we apply it to those super-wealthy individuals who have managed to privatise the post-communist state itself. They are not unlike the “boyars” of early tsarist Russia, a class of wealthy individuals who used politics and the state to gain wealth rather than the other way around. It is only in Russia, toward the end of the Yeltsin years where we see cases of the latter – i.e., state capture by the new wealthy.

As the newly recreated Russian state began to collapse, the largest business conglomerates began to build up their own armed security forces, occasionally with as many as 1,000 mercenaries. Indeed, important businessmen needed security forces, since the city of Moscow was ruled by mafia organizations, usually run by Russians or Chechens, and without the protection of one or the other, life was virtually impossible for such business figures. Two such figures, Gusinsky (protected by Russians) and Berezovsky (protected by Chechens), suspected each other of being responsible for assassination attempts and of plotting to frame each other with the help of law enforcement. Finally, in 1996, these two giant oligarchs negotiated an agreement to cooperate, rather than destroy each other.

Berezovsky is the best example of an oligarch. After Yeltsin’s 1996 re-election as president, Berezovsky became involved in affairs of state, serving as Deputy Secretary of the National Security Council in charge of Chechnya. As many of his bodyguards were Chechens, he had working relationships with the Islamist leaders responsible for the Chechen uprising. Even after Berezovsky left this position, he continued to negotiate with Chechen rebels to free hostages. Berezovsky used his business success to gain substantial political power and eventually political office; many commentators assumed he used this office to enrich himself personally.

### *Capture of oligarchs by autocratic rulers*

In 2000, Berezovsky and some of the surviving members of the Big Seven (namely Khodorkovsky and Fridman) supported Vladimir Putin's election campaign, bringing Putin "into the family", to use the language of the mafia. Even so, Putin was no Yeltsin; he wanted to be Peter the Great and refused to be bossed around by "boyars" – i.e., oligarchs. Although Berezovsky was elected to the Duma (the Russian legislature) in 1999, he soon clashed with Putin and fled to England. He was later accused of various murders and sentenced to prison in absentia.<sup>1</sup> Berezovsky became public enemy number one for Putin's Russia; it is rumoured that Russian agents made several attempts to murder him in London. He passed away in 2013 in mysterious circumstances. Berezovsky might have been killed by Russian intelligence services; it is also possible that he lost so much of his wealth (mostly to Abramovich) that he was unable to adjust to a more frugal lifestyle and instead committed suicide.

Like Berezovsky, Khodorkovsky was also too politically ambitious for Putin. In early 2003, sensing trouble with Russia's new political boss, Khodorkovsky proposed to merge Yukos with the other major Russian oil company, Sibneft. When Berezovsky was forced to flee Russia, he passed ownership of Sibneft to Roman Abramovich (who was already ranked number two on lists of the wealthiest Russians in 2009), who regarded Berezovsky as his mentor. In 2003, Khodorkovsky was put on trial for corruption and sentenced to prison. He was released in 2013, after which he moved to Switzerland with a small portion of his former wealth. In 1999, he was believed to be worth \$500 million; today his assets are estimated to be around \$100 million. While Khodorkovsky was "eliminated" by Putin, Abramovich has been a survivor. This may be due to the fact that unlike Berezovsky or Khodorkovsky, he has kept a low profile and assured Putin of his unconditional loyalty. As a reward, he inherited a great deal of property from his former mentor and bitter enemy, Berezovsky.

Excessive rent-seeking threatens the legitimacy of the post-communist regimes and even the institution of private ownership. In response, political elites have launched anti-corruption campaigns. However, it remains to be seen whether such anti-corruption drives will actually reduce rent-seeking, or if they are merely instruments with which to remove political enemies or to reallocate the wealth of oligarchs whose loyalty is in doubt. Khodorkovsky was jailed on charges of corruption, but it was hard not to see political motives behind the struggle between Putin and Khodorkovsky. It is thus possible that these corruption charges were instruments for the *selective criminalisation* of Putin's enemies. Many members of the economic and political elites of the post-communist era are likely to have skeletons in their closets that would also make them vulnerable to such prosecutions.

Executives in such conditions – given the ambiguities of legal regulations and private ownership in post-communist societies – may be even more likely to offer their gratitude (or bribes) to politicians. And even in more established liberal democracies, political elites may be

<sup>1</sup> While no murder charges against him were ever proven in a fair court of law, he was suspected of involvement in the murder of Vlad Listyev, Russia's most successful TV producer, who was killed four years earlier. Listyev supported the privatisation of TV 1 and its sale to Berezovsky, but he advocated fair pricing for advertising time, which clashed with Berezovsky's interests.

inclined to accept thanks (bribes) for their services. There are many candidates labelled as “corrupt”; the question is, “Who will be selected in the end?”

In 2012, when the Communist Party of China transferred power from President Hu to President Xi, authorities launched a new anticorruption campaign, promising to catch “tigers and flies.” So far, they have caught quite a few flies and some tigers, but those tigers look very much like the political enemies of those in the highest positions of political power.

The first tiger to be subjected to an anti-corruption investigation was Bo Xilai. Bo was the first secretary of the Communist Party of Chongqing, the largest city in the world, and an aspirant for a position on the Standing Committee of the Politburo. He was a Maoism-inspired left-populist politician. He kept speculators out of the urban land market and used the profits from that market to build public housing, schools, and medical facilities (Huang 2011). Although people had to sing songs from the era of the Cultural Revolution, they received better services. Bo Xilai appeared too popular and too dangerous to the Beijing establishment. Although he was not completely innocent, his selection as the first “tiger” may have had more to do with his candidacy for the Standing Committee of the Politburo than with his involvement in corruption. The case against Bo Xilai started with the prosecution of his wife Gu Kailai. Gu was convicted and eventually sentenced to life in prison for the murder of an English business associate, Neil Heywood. She might have been the murderer, but Heywood’s body was cremated immediately after his death, preventing an in-depth forensic analysis and hindering the criminal investigation. Nevertheless, in 2012, a court took seven hours to find her guilty and sentence her to life.<sup>1</sup> Eleven months after his wife’s trial, Bo was tried on charges of corruption and abuse of power. He was found guilty of having received bribes totalling \$3.6 million from two local businessmen. He may very well have taken these bribes, but what is curious is why top party leaders, whose family fortunes count in the billions of dollars, are not also under investigation for the suspicious speed with which their wealth has accumulated.

Selective criminalisation and “capturing” the *nouveau riche* are not exclusively Russian or Chinese phenomena. Some commentators suspect that the Romanian President Klaus Iohannis’ anti-corruption drive may also be politically motivated, and there is little doubt that witch-hunts are also widely used in Hungary, especially since 2010. The centre-right government there has accused many former socialist and liberal politicians of corruption. After spending long periods in “pre-trial detention”, most of these politicians have been found not guilty by relatively independent courts. The Hungarian government made another interesting case in moving against a “newly rich” businessman for perceived disloyalty. Lajos Simicska, the former treasurer of the party that has ruled Hungary since 2010 (Fidesz) and a winner of many restricted competitions for government contracts, suddenly fell out of favour with the Prime Minister. By the end of 2014, Simicska was excluded from public-procurement tenders, and all government advertising had been pulled from his media firms. Most recently, even the hunting plot he rented from a state-owned forest farm was taken away from him. As the

<sup>1</sup> Without a body or a murder weapon, one would have expected a somewhat longer trial. She confessed, but the usual sentence for murder in China is capital punishment.

Prime Minister put it, “Trees cannot grow into the skies”<sup>1</sup>. Unlike Khodorkovsky, Simicska is not in jail, but his business empire is in serious trouble. In 2016, another former Hungarian oligarch, Zsolt Spéder, suffered a similar fate; he had been allowed (or instructed?) to build a financial conglomerate out of a renationalized commercial bank and the 100% state-owned national post company. While under police investigation, he has been forced to give up his banking empire and his real estate holdings and will probably lose his media portfolio.

### *Consequences of inequalities*

Before we move further, let us put the institution of rent in brackets for a moment, as if it did not exist or did not matter to society. As long as wages are on the rise, rent-seeking is a positive-sum game, as we argued at the beginning of our chapter. Neoclassical equilibrium models are all based on this assumption, which was perhaps not very far from reality until recently. Globalisation, however, has radically changed the outcome of the game.<sup>2</sup> While profits have been rising in many sectors of the US, Germany, and other large economies, real wages in those same sectors have been stagnating as a consequence of – *inter alia* – outsourcing and the growing share of the financial sector. Thus, we agree with Piketty that the wage-profit relationship in advanced Western countries could become a negative-sum game for low-skilled workers and employees, which will in turn fuel populist sentiments against globalisation, migration, the highly educated and highly paid business executive in particular.

Having said this, we still assert that inequality is only loosely related to economic growth or social stability. In some societies – the United States, for instance – high levels of inequality are generally accepted; despite a GINI coefficient over 0.40, the US still enjoys relatively robust growth and a reasonable level of social stability. Other societies (in Scandinavia, for instance) tend not to tolerate inequality but still produce good growth rates and high levels of social stability.

The current which runs counter to Piketty is that increasing levels of inequality do not necessarily lead to political instability. Important counterexamples can be observed both in Western and post-communist democracies and in post-communist authoritarian regimes. The underprivileged poor are inclined to abstain from voting in elections; this holds for such divergent countries as the US and Hungary, and political elites are fully aware of it. In a vote-maximising strategy, pro-poor policies simply do not pay off. In authoritarian China, where elections are largely ceremonial, inequalities have skyrocketed, but so far, the popular response has been mute. Economic growth has been phenomenal there since 1978; this rising tide has lifted the boats of hundreds of millions of people out of poverty, though at very unequal speeds. People may therefore accept more inequality as long as their prospects for a better life seem secure. Martin Whyte (2010) found that inequality was not

<sup>1</sup> This metaphor was used at a semi-closed gathering of Fidesz party leaders, as reported in the Hungarian daily *Népszabadság* on 8 September 2014.

<sup>2</sup> See Solow (2015), who bluntly acknowledges this.

a major concern for ordinary Chinese citizens; Russians' experiences of the first few years of the 21<sup>st</sup> century were similar.<sup>1</sup>

Furthermore, both everyday experience and academic research show that ordinary people tend to have little understanding of the true (i.e., statistically measured) size of the inequalities in their own countries. With a variety of large, cross-national surveys, Gimpelson and Treisman (2015) demonstrated that what people think they know is often wrong. On their list of 40 countries, the "least correctly informed" people are the citizens of 8 post-communist countries (Ukraine, Hungary, Croatia, Slovakia, Estonia, Poland, Slovenia, and the Czech Republic), while at the top of this list we find two rich welfare states (Norway and Denmark).<sup>2</sup> Moreover, these authors showed that the *perceived level of inequality* – not the actual level – strongly correlates with ideologically motivated demands for redistribution and the reported level of conflict between the rich and the poor.

What seems to annoy people – ordinary people and social scientists alike – is the knowledge or the presumption that successful entrepreneurs (and especially the most successful ones) are greedy, dishonest, and corrupt. During the recent financial crisis, the North American media used "Main Street" to represent the interests of everyday people and small-business owners, and "Wall Street" (in the United States) or "Bay Street" (in Canada) to symbolise the interests of highly paid managers working for large banks and corporations. In Southern European countries like Bulgaria, Romania, and Greece (or in Latin America), the prevalence of corruption is an important cause of political instability and strikingly low levels of trust in market institutions.

## Conclusions

As we have already shown, using the example of Ricardo's failure to "scientifically" predict the rise of scarcity rent for agricultural land, it is inherently impossible to predict the future trends of other types of rents, too. As the last 20 years have exemplified, rents on oil-and-gas extraction can vary enormously, and with them, so do the relative income positions of the workers in these fields. In Central and Eastern Europe, the funds flowing from the European Union are the main drivers of the rent-seeking practices of those firms, individuals, local governments, etc., which are close to centres of political power, where access to EU funds is controlled.

The main implication of the present chapter is that the crucial issue is not the extent of measured inequality (in incomes or wealth). A capitalist country with a GINI coefficient of 0.40 can be as economically dynamic and socially cohesive as one with a coefficient of 0.20. Beyond pre-capitalistic legacies like ethno-racial conflicts, religious cleavages, and gender-based pay

1 Our recent paper Mihályi – Szelenyi (2017) is devoted entirely to the role of rents in the transition process from pre-1989 socialism to the present-day capitalist system.

2 The list was compiled using responses to a questionnaire which asked people to choose the income-distribution diagram with the Gini coefficient closest to the correct one for their country in 2009. At the top, 61 % of the Norwegian respondents correctly chose the diagram which represented the distribution of their post-tax-and-transfer incomes, while only (!) per cent of the Ukrainian respondents did so.

gaps, as described in Mihályi – Szelenyi (2016b), our key political-economy question in this chapter has been whether profit-seeking or rent-seeking is the mechanism that generates inequality in Western-type democracies and in the post-communist states. We conclude that the statistically measured changes in the distribution of wealth at the level of society cannot be explained by the secular rise of profits, as Piketty contends. Since the 1970s, rents have played an increasingly important role.

Our second assertion is that rents are not anomalies in liberal market economies. Strong institutions guarantee their recurrence. Different types of rents exist. Some of them are obviously harmful and deplorable, while others are unavoidable or even indispensable. Hence, our contribution to the current literature is a largely value-neutral re-introduction of the Ricardian concept of rent. At the same time, we do not doubt that rents, rent-seeking behaviour, and increasingly large inequalities of wealth can be destructive. There are two such potentially destructive institutional arrangements: state capture by private businesses and market capture by political elites. These are obviously harmful phenomena; they threaten the legitimacy of both the varieties of capitalism under discussion here – the traditional Western type and the post-communist model – and undermine their economic efficiency.

## 10. The Two Forms of Modern Capitalism: Liberal and Illiberal States. A Criticism of the Varieties of Capitalism Paradigm

### *Introductory remarks<sup>1</sup>*

In a path-breaking article, the American political scientist, Francis Fukuyama (1989) predicted “the end of history”, the *final victory* of Western capitalism and liberal democracy *over socialism*. His point of departure was that the fall of communism – the only historically proven, durable and viable alternative to the capitalist system – changed the course of the world, after Fascism (the other alternative) proved to be short-lived by historical time standards.<sup>2</sup> It is important to note that Fukuyama was a confessed neo-conservative, rather than a US Democratic Party liberal. His seminal paper was published in *National Interest*, a journal founded by Irving Kristol, the first of major theorists who identified himself as a neo-conservative as a distinction from President Johnson’s “liberalism”. Kristol resented affirmative action and the redistribution from the rich to the poor.<sup>3</sup>

Indeed, as we presented in Szelényi-Mihályi (2020) in more detail, 70 years after the Bolshevik revolution, 26 socialist countries stretched over 31% of the land of four continents. In 1987, their combined population amounted to 34% of the world’s total. If we use the world’s political map of today, we can identify 56 existing countries, which, for a shorter or longer period, were rightly labelled socialist<sup>4</sup> by experts of the outside world. The first two decades following the publication of Fukuyama’s seminal article saw a spectacular retreat of socialist systems worldwide and the expansion of liberal market economies. According to the metrics used by *Freedom House*, the number of “free” countries rose from 57 in 1987 to 90 by 2007. Then, as we know from the publications by Larry Diamond (2015, 2019) and others, as well as from Freedom House data, the liberalization/democratization trend reversed. As from 2005, the

1 Published in *Comparative Sociology*, Vol. 19, 2020. Issue 2, 155-175.

2 Fukuyama (b. 1952) was extrapolating the analysis of his mentor at Harvard, Samuel Huntington (1927-2008), who in 1991 wrote an agenda-setting work on the third wave of democratization. Huntington’s point of departure was the 1974 anti-fascist revolution in Portugal which was indeed followed by a world-wide democratization between 1974 and 1990. Thus, by 1989, fascism was a non-issue for Fukuyama or anybody else.

3 Irving Kristol much like many of the so called „New York intellectuals” (Daniel Bell, Nathan Glazer, Seymour Martin Lipset), came from the left (or occasionally even communist far left) of the Democratic Party. They eventually became „liberals”, but with the „Great society idea” of Lyndon B. Johnson they resented this left-wing shift of the Democratic Party and began to call themselves as “neo-liberals”. The “Great society liberals” revolted against them being identified as liberals hence they suggested they are really neo-conservatives (Michael Harrington, 1973). Kristol accepted this label (1979) - so did Fukuyama. For them the “end of history” primarily meant the victory of US style of capitalism, though they anticipated capitalism be followed almost automatically by liberalism and democracy. Some warmed them early on (Huntington, 1996, Jowitt, 1993); the emergent capitalism may not be all that liberal or democratic, rather than becoming “civil” they can become more “ethnic-based”.

4 Taking our lead from Kornai (1992), we simply use socialism and communism as synonyms: we also use the terms interchangeably.

number of countries that became illiberal (“unfree”, “partially democratic” or “authoritarian” in the *Freedom House* terminology) increased, and the number of “free” states went back to 86 by 2018.<sup>1</sup> This decline of democracy has been a global tendency, but it was surprisingly strong in post-communist Eastern Europe (Enyedi, 2015, Bieber et al, 2018. Szelenyi – Mihályi 2020a).

### *Liberalism and illiberalism*

In our reading, the notion of liberalism is broad, and it goes back to John Locke (1682-1704), further elaborated by Montesquieu (1689-1755), and finally institutionalized in the American Constitution (1788). In this interpretation, the essence of liberalism is a relatively weak executive, which is bound by the laws passed by an independently established legislature and monitored by a judiciary, which is at equal distance from the executive and the legislature. For Locke<sup>2</sup> and Montesquieu, this was a program to move from an absolute to a constitutional monarchy. They both believed that the executive would be the monarch but bound by a constitution and law applicable to all.

For Locke ([1698] 1988), it was evident that such a separation of powers is necessary to guarantee individual liberty. Otherwise, the defense of minorities becomes impossible (Kis, 2003).

*“Men being all the workmanship of the one Omnipotent... [T]hey are his property... [M]ade to last during his, not one another’s pleasures...[T]here cannot be supposed any... subordination among us... The state of nature has a law of nature to govern it... and reason, which is that law, teaches all mankind, that being all equal... no one ought to harm another in his life, health, liberty, or possession.” (p. 271)... The natural liberty of man is to be free from any superior power on Earth... The liberty of man, in society, is to be under no other legislative power, but that established, by consent....(p.283)...Freedom of men under government is to have a standing rule to liberty, common to everyone of that society, and made by the legislative power erected in it”* (Locke, op. cit. 284).

Max Weber (1864-1920), more than two hundred years after Locke, also emphasized that the essence of liberalism is the freedom of individuals from personal masters.

*“Legal authority rests on the acceptance of the validity of the following ideas: ....[L]aw ...[is]... a consistent system of abstract rules which ...[was]...intentionally established.....[P]erson in authority, the ‘superior’, is himself (subjected to these rule) ...[T]he person who obeys authority.... obeys only the law...[Members do not owe obedience to [superior] as an individual, but to the impersonal order...”* ([1920]1988), pp. 217-128).

*Liberalism and capitalism.* During the 17<sup>th</sup> and 18<sup>th</sup> centuries, classical theorists of liberalism were not interested in the economic consequences of liberalism (since capitalism hardly existed). By the 20<sup>th</sup> century, for Max Weber, this became the single most important question. Weber believed that capitalist systems function effectively only under “legal-rational authority”.

1 <https://freedomhouse.org/report-types/freedom-world>, last visited: 20 February 2020.

2 Interestingly Locke did not see the judiciary as an independent branch, his third branch was the „federative” the right to conduct wars and foreign policy, but he was inclined to believe the executive should exercise those powers. The US constitution left this vague, and it is a subject of controversy between Congress and the President ever since.

While individual profit-seeking capitalist entrepreneurs can operate even in *traditional* and in exceptional cases in *charismatic authority*, a system integrated by the logic of profit-seeking capitalism is only conceivable under a legal-rational or liberal regime (Nee – Svedberg, 2007).<sup>1</sup> The reason is simple. Capitalism needs a secure and predictable environment, the rule of law, which is only possible if the three major branches (legislature, executive and judiciary) of government are at least to some extent separated.

No matter how committed Weber was to the separation of powers, he spotted serious problems with it:

*“The constitutional separation of powers is a specifically unstable structure. ...[W]hat would happen if a constitutionally necessary compromise, such as that over the budget, were not arrived at. Still separation of powers establishes spheres of authority – introduces calculability, good for economy.”* ([1920] 1988), pp. 282-283).

This is typical ironic Weber, but also prophetic at the same time. Weber followed the scenario of Montesquieu. When the legislature and the executive are truly independent, the legislature has only the right to give the budget to the executive. If the legislature is not willing to pass the budget the executive desires – and indeed, as we see time and again in the United States –, the political fight may end up in “chaos” and government shutdown. Eventually, though, this is still good for the economy, since it forces either the legislature or the executive to compromise, and it is exactly this compromise that offers a predictable environment to capitalism.<sup>2</sup>

This is equally true for the judiciary. An independent judiciary is absolutely vital so legislature cannot pass anti-constitutional laws; the executive is bound by the constitution and the laws. Nevertheless, as we have seen during the first four years of Donald Trump’s presidency, it is a long and painful process for the legislature to stop the illegal actions by the executive. Later in this paper, we will try to demonstrate through the rise of illiberalism how this conflict can fuel the “anti-establishment” and “anti-elite” sentiments of the electorate and lead to a desire for strong and effective leadership (Enyedi, 2015).

*Varieties of liberal capitalism.* The idea that capitalism has different forms is not new. Already Marx (1818–1883) considered a critical distinction between “productive” and “finance” capitalism. The first is capable of self-reproduction, while the second was thought to be self-destructive. Karl Polanyi (1944) – at least in our interpretation, see Szelenyi – Mihályi, 2020b - could also imagine a self-correcting capitalism (correcting the destructive features of pure markets).

1 There was a lively debate during the late 19th century, which curiously seems to be relevant to our debates about liberalism and illiberalism today. Karl Bücher (1893) claimed that the ancient „*oikos*” was a unique, in no sense capitalist form, while Eduard Meyer (1893) questioned the usefulness to invent a special term for the antiquity. He had no problem to identify Ancient Rome as a capitalist economy. Weber offered a compromise: there were profit-seeking ventures in Antiquity, but it did not add up to a capitalist system (Reining, 2001). In the next sub-section of this chapter when we discuss illiberalism, like Weber, we will accept that there are profit-seeking firms under illiberalism, but to what extent the economic system is capitalist – or democratic – will remain open for debate on a case-by-case basis.

2 It goes without saying that the capitalist system in itself is rich in conflicts between labor and capital and among various fractions of capital.

In this paper, we combine the *Varieties of Capitalism* (VoC) paradigm of Hall and Soskice (2001), with Gøsta Esping-Andersen (1990) book, *The three worlds of welfare capitalism*. While VoC offers a firm-centered approach, Andersen built a typology of welfare states. These works are Euro- and Euro-Atlantic centric, and thus they put liberal democracies in the focus of research. State intervention is different in terms of the extent and nature of state involvement, but there is no doubt about the *liberal and democratic* nature of the regimes: the executive, legislative and judiciary branches of government are clearly separated. As a first step, we slightly reinterpret these ideas in macroeconomic terms by distinguishing three versions of liberal capitalism:

- (a) Liberal market economy, with as little state intervention as possible: the Anglo-Saxon model (especially during Thatcher's and Reagan's time);
- (b) Corporatist-statist model, with substantial welfare intervention by the state, but in a targeted manner (the purest type is the German model, called in 1949 by Adenauer's finance minister, Ludwig Erhard *Soziale Marktwirtschaft*, with targeted welfare assistance). Former socialist countries like the Baltic countries, Czech Republic, and Hungary (until 2009) tried to move in this direction with varying success.<sup>1</sup>
- (c) Social democratic systems (Scandinavian models, with universal insurance schemes).

These categories are value-neutral. All the exemplified countries meet fully the criteria of liberal, democratic, and meritocratic societies. Germany is not better or worse than the USA or Sweden – they are just different. And the differences are not even random: they are explained by the different preferences and priorities of the voters. The same holds in a comparison, say, of Ireland and Austria. This is the reason why these latter two countries can reasonably cooperate in the European Union. As the subtitle of the Hall-Soskice book explains, all capitalist countries have institutional foundations that suit them best to exploit their “comparative advantage”. E.g., liberal market economies are usually strong in innovation; corporatist-statist model usually offers high-quality products (compare the quality of cars or any other product between the US and Germany) welfare states reduce social tension and generate solidarity.

The golden age of liberal capitalism came to an end by the 1970s (especially triggered by two international oil crises). The post-WWII fast growth, reduced inequality, and improvements in well-being all came to an end. As Christian Joppke (1987) called it, the world moved into the “neoconservative model<sup>2</sup> of capitalist growth”, financial discipline, austerity measures and cutbacks in welfare expenditures. The two or three sub-models of liberal capitalism identified by several authors in the last decade of the 20<sup>th</sup> century seemed to be merging into one, moving closer to the US-style “liberal market economy”. In a way, this is what *globalization* is

1 While in the above named post-socialist countries there was a strong support – at least by part of the electorate – for a liberal market economy, from day one ethno-nationalist, illiberal tendencies were strong. The examples are strong anti-Russian feelings and even policies in the Baltic States, anti-European, sovereigntist attitudes of Czech prime ministers, presidents, like Václav Klaus or Miloš Zeman, attempt by the Antall government in Hungary to bring public media under government control, clientelism under the Horn and the first Orbán government on Hungary, etc.

2 Already in footnote 4 we indicated the difference between neo-liberal or neo-conservative regimes. In terms of economic policies, they are largely indistinguishable. Neo-cons accept political programs (in the US, especially military intervention around the world) what neo-liberals may not support).

mostly about. The classic Scandinavian welfare state faced serious problems, given its high taxes to cover the generous welfare provisions. In the globalizing world, capital could move almost without restriction, so there was a capital flight from high-tax countries into “tax havens”. But it would be premature to bury the welfare state. Expenditures in social welfare – measured as a proportion of the GDP are still much higher in welfare states than in liberal market economies and even in these societies political pressure to improve their welfare system is increasing (see Bernie Sanders’ “democratic socialist” mass movement - in the US) In addition, US-style liberal market economies do have their own problems stemming from globalization. One result of globalization is the explosion of inequalities at the top of the social hierarchy, while in the bottom 30-50 %, incomes tend to stagnate. As a result, even liberal capitalist economies are vulnerable to illiberal, anti-globalization rhetoric, which Donald Trump cashes in so effectively and which Boris Johnson used to “get Brexit done”. The coronavirus scare adds more fuel to the anti-globalization hysteria.

*Liberalism and democracy.* Liberalism, however, does not require democracy. Capitalism can live with democracy, but it certainly does not require it. Almost to the contrary, democracy tends to create a system where decisions are made slowly, a complicated system of bargaining and negotiations, which capitalists eventually accept as long as the liberal principles are maintained.

### *According to Weber*

*[N]orms [laws] may be established by agreement or by imposition, on grounds of expediency or value rationality or both...Free representation undermined the economic base of older status groups... Calculability and reliability is vital to rational capitalism... so bourgeoisie imposed checks on monarchs... In early stages property qualification defended the power of propertied class against the proletariat...Occasionally monarch advocated universal suffrage – hoping proletariat will be conservative force against bourgeoisie... ([1920]1988) pp. 296.)“.*

Hence you have a liberal order where *“laws are not arrived at by agreement but are imposed”*. And what is even more intriguing, parliamentary free representation was the product of the struggle between monarchs and the bourgeoisie. Weber was of course, right: capitalists were not among the main advocates of liberal democracy and universal suffrage.

With the US constitution (1788) and the French revolution (1789) the liberal program took a “republican” turn, where the executive was not seen any more as the monarch (as it was the case for Locke and Montesquieu), but an elected person or body, and the legislature is also conceived as an elected body (though still far cry from universal suffrage). It took more than a century to turn this into a “liberal democratic” system by the early or mainly mid-20th century, when voting became based on universal suffrage.

The received wisdom was for quite some time that democracy is the outcome of economic development (Lipset, 1960). But even this position proved to be too simplistic. Scholarship from the mid-1980s challenged this assumption (Korpi, 1983, Gosta Esping-Andersen, 1985, Rueschenmeyer *et al.* 1992, Usmani, 2018). Weber was quite on the dot when he defined

“legal rational authority” (liberalism) without assuming that such countries were necessarily democratic. Weber emphasized the importance of aristocracy to push for universal suffrage, but labor parties, liberal parties, feminist movements, and minority rights movements (by African Americans, Native Americans, etc.) also played a significant role in achieving universal suffrage, even if this took over 100-200 years. Let us remind ourselves that universal suffrage in the US was achieved only in 1965, when, finally, Native Americans also got the voting rights.<sup>1</sup> But eventually, most liberal capitalisms were likely to turn into liberal democracies, with universal suffrage.

In sum, capitalism is most likely to flourish under liberalism (rule of law) and especially under liberal democracy. But dynamic growth is conceivable – and did occur – in *non-liberal* or *illiberal* capitalist states. In the “soft” version of illiberalism, while the independence of various branches of powers is undermined, regular elections are still held and they have a stake, even if the electoral rules are managed to favor the ruling party (Japan, Turkey, Russia (under Yeltsin), India, Hungary (since 2010), Singapore, Taiwan, and Poland (since 2015). The same is true even in *certain dictatorships* as long as they guarantee some degree of law and order at least in the sphere of business (e.g. Russia under Putin, Singapore, Chile under Pinochet, or the United Arab Emirates). We call these cases the dictatorial subtype of illiberalism. In such “hard” versions of illiberalism, even if elections are held, they have no stake, although there is a relatively independent judiciary as far as the business world is concerned.

If, however, the ruler is *despotic*, where he can act as he or (rarely) she pleases, the capitalist system cannot be constituted, though profit-seeking firms owned by clients of the ruler may exist. By and large, this is the case, currently Iran, in the Gulf monarchies, in Russia, in several post-Soviet republics and in China (1978-2012).<sup>2</sup> The drastically reduced separation of powers is typically accompanied by ethno-nationalist, anti-globalist, and mercantilist policies as well.

*The shortcomings of the VoC approach.* With the benefit of hindsight, in our opinion, it was a mistake to forget about the illiberal forms of capitalism, as the VoC doctrine did. Their categorization applied merely to a numerically small group of highly developed, liberal states (to 17 OECD countries, to be precise<sup>3</sup>), and all the illiberal capitalist states were simply left out of the analysis. This is odd because the great lesson of the past 15 years is that, in contrast with Weber’s assumptions so far, the illiberal versions of capitalism, in growth terms,

1 Even this is contested in some US states. The debate is about the “technical” conditions African Americans are allowed to vote (whether they need a driver’s license – some African Americans do not have one) and the exclusion of “ex-convicts, even if they completed their terms, etc. (Manza-Unger, 2006)

2 During the post-Stalinist and post-Maoist system, communism was moving into this direction of hard illiberalism. The case of fascist or Nazi systems is rather complicated. Mussolini or Hitler had substantial support from big businesses, though they did not offer the guarantee of security of property. Crown Prince Muhammed bin Zayed of Abu Dhabi, who claims to be the source of all laws, recognizes certain business interests and offers enough security to businesses to operate in a capitalist system. The classification of China after 2012 is a difficult task. See the present authors’ views in Szelenyi – Mihályi (2020a).

3 As of 2020, the OECD has 36 Member Countries. Among the countries missing from the Hall - Sockice (2001) list were the Mediterranean countries (as already noted), 8 former socialist countries, plus Chile, Israel, Korea, Mexico and Turkey. Surprisingly, France was also left out of the original 17-member list, as a country with “ambiguous position” (*op. cit.* pp. 20-21.).

performed in an impressive way (South East Asian countries or India being prime examples). Whether we like it or not, this is undeniable.

The other contribution of our present paper to the existing literature – and to the VoC approach in particular – is that our study is not firm-centered, but state-centered. We are deeply convinced that in the globalized world economy, the existing differences among firms' behavior (industrial relations, vocational training, corporate governance, inter-firm relations, and coordination with employees) on which the original VoC approach is based<sup>1</sup> are of secondary importance only. Furthermore, history has simply not justified the assumption of “increasing divergence between the coordinated and liberal market economies”.<sup>2</sup> If anything can be said about the direction of change after the 2008 international financial crisis and the ensuing institutional, as well as intellectual changes pertaining to macroeconomics, it is the opposite. The liberal democracies of the core OECD or EU countries became more similar than before. All the firm-centered differences between Germany and Britain, or France and the United States, have become insignificant, if compared to the differences between liberal economies like these four on the one hand, and the illiberal capitalist democracies, like Japan<sup>3</sup>, Russia, Turkey, or India on the other hand.<sup>4</sup> If this were not the case, the European Union would have fallen apart a long time ago. Similarly, the Brexit conflict or the trade war between the Trump presidency on the one hand, and the rest of the world on the other, has very little to do with the differences between Liberal Market Economies (LME) and Coordinated Market Economies (CME). The origin of all these conflicts is at the level of state politics.

*The Hungarian version of illiberalism.* In 2014, the Hungarian Prime Minister, Viktor Orbán (b. 1963), brought into the public discourse a new dimension (Bozóky, 2019, Kovács – Trencsényi, 2020). Orbán, a former radical liberal, spectacularly turned into a major critic of liberalism.<sup>5</sup> He was inspired by the widely known American political scientist, Fareed Zakaria (b. 1964), who first introduced the notion of illiberal democracy in 1997. For Zakaria, the notion of illiberalism had negative connotations: a country which is illiberal could not be genuinely democratic. According to Heller (2019), in this sense, illiberalism is a new phenomenon. It is tyranny with a negative ideology: nihilism.

Orbán (2014), with a stroke of genius, turned “illiberalism” into a positive term (without referring to Zakaria) in a widely quoted public lecture after being re-elected as Prime Minister for the third time. A newly converted anti-liberal, he offered a criticism of liberalism. In his reading, liberalism puts excessive emphasis on individual liberty and interests and does not sufficiently respect the national interest.

1 For this five-member list, see Hall - Soskice (2001) 68-page long introductory and summarizing study, pp. 6-7.

2 See Kathleen Thelen's (2001) clear-cut position in the Hall - Sockice edited volume, op. cit. p. 72.

3 It is worth noting that the VoC approach does not question the liberal credentials of Japan. We do this, despite the ironic fact that the Liberal Democratic Party (LDP) has almost continuously been in power since its foundation in 1955 (except for a period between 1993 and 1994, and again from 2009 to 2012).

4 In fact, this is the real reason why the EU has become increasingly hesitant to open the accession talks with Turkey.

5 In 1992, Orbán was elected Vice Chairman of the Liberal International (LI). In 2000, however, Orbán and his Fidesz party left the LI and joined the European People's Party (EPP). From this date, Orbán showed more and more signs of intellectual enjoyment of illiberal actions and statements. Scheppele – Bánkuti (2012).

Orbán has a law degree, so he is well aware that the connection between individual and collective (he calls it national) interest is a complicated one. He must have learned (and probably still remembers) that already Montesquieu Jean-Jacques Rousseau (1712-1778) had struggled with this problem. Rousseau ([1762], 1993) knew that he had a big problem. If individuals do not know what their interests are, who will know it?

*“To discover the best rules of society suited to each Nation would require a superior intelligence... The Lawgiver is in every respect an extraordinary man...BUT: a/ “He who drafts the laws has or should have no legislative power”; b/ The wise who would speak to the vulgar in their own rather than in a vulgar language will not be understood by them Lawgiver uses neither force nor reasoning, he must of necessity have recourse to an authority of a different order, which might be able to rally without violence and to persuade without convincing.”* (op. cit. pp. 213-216)

Rousseau offered a troubling solution. People have to be forced to be free (and understand that the general will is more than the sum of their individual wills), and the only ones who can see the general will are “the wise men”, intellectuals like the author (i.e., Jean-Jacques Rousseau himself).

The second author of this paper, Ivan Szelenyi wrote a book in the 1970s about the “intellectuals on the road to class power” (Konrad and Szelenyi, 1979) which was in a way consistent with Rousseau, though with a twist of irony. The Konrad-Szelenyi book was not a project for grabbing power by intellectuals; it was an ironic criticism of such aspirations. Indeed, the political “class”, which came to power in 1990, was dominated by intellectuals, historians, writers, and sociologists (and not only in Hungary). But unlike the intellectuals the Konrad-Szelenyi book surveyed, they did not want to “rationalize and humanize socialism”, they were now committed to “build” capitalism and create a class of property owners.

This is intriguing and tells a lot about the inherent “anti-intellectualism” of illiberals and their commitment to launch a “cultural war”. In 2002, Orbán lost the election unexpectedly, he was in some way self-critical. He said: Our mistake was that we did not create during my government a loyal domestic bourgeoisie. After 2010, when Orbán and his Fidesz party returned to power, they did not make the same mistake: they fervently supported with money their own loyal entrepreneurs in many sophisticated ways. After 2014, they realized that they also had to create a loyal intelligentsia. This seems to be underway in the last couple of years as a “cultural war” against liberal intellectuals. Quite recently, Orban (2020) went so far that he even denied the existence of liberals: “There is no such thing as a liberal: *“a liberal is nothing more than a communist with a university degree”*.

However, illiberalism is far from just a Hungarian or Orbán phenomenon. What we observe now is nothing less than an all-out *ethno-nationalist, sovereigntist counter-revolution* against liberal democracies in 18 (!) EU Member States and on other continents as well. These illiberal counter-movements and political parties so far have not captured the majority votes in the most recent national elections, but the share of these right-wing parties among the voters

is already in the 11.0% (Latvia) to 49.3 (Hungary) range.<sup>1</sup> Often, this is enough to have the majority of parliamentary seats or to receive a few ministerial positions in coalition governments. This counter-revolution calls for a potent executive, whose actions for the “national” interest are not blocked by institutional checks and balances. The essence of illiberalism is to overcome the wishy-washy parliamentary paralysis and replace it with an executive that is capable of acting swiftly in all circumstances.

*Illiberalism and capitalism.* Can illiberalism co-exist with capitalism? In our definition, *illiberalism* is a project to reduce the separation of powers and, in particular, to increase the power of the executive. This has major implications for political economy. Given the strength of the illiberal executive, the state interferes substantially in market competition, especially in the process of public procurements. Competition is often limited either to agents (or *Strohmanns*) of the political decision-makers or to the clients of the political elite. Since competitors are thus eliminated (or at least their number is substantially reduced), certain businessmen can win such “competition” by asking higher prices for their products or services than what they could gain in open competition. They collect *rent* on top of the *profit* they earn. If rent-seeking becomes systematic, it reduces efficiency. If rent-seeking is manifestly widespread, it may even threaten the sustainability of the system (as it is documented in several African “failed states”)

Some *rent-seeking* exists in all capitalist economies (Mihályi – Szelenyi, 2019). But in liberal states, it is less evasive, and it is usually not the outcome of direct government intervention. Rent in this sense is similar to what some 20<sup>th</sup> century Marxist economic textbooks call *extra profit* that monopolies or oligopolies generate. If the government limits competition in public procurement for *Strohmanns* or clients in hidden ways, we call this *corruption*. If, in turn, politicians are caught in such activities, they are prosecuted. In illiberal capitalist economies, such targeted government intervention is one of the most important goal functions of the system. Furthermore, the illiberal leaders are inclined to use selective criminalization through which they can eliminate their real (or suspected) opponents. In case, *Strohmanns* are protected from the market competition that often serves the enrichment of the political elite (or their families). This is what Bálint Magyar (2013, 2016, 2019) calls a *mafia state*.

But since illiberal regimes also have to claim that they are “democratic”, they have regular elections, and these elections have some stake. In other words, the ruling elites have to win the elections for their legitimacy. As a result, rent seeking means much more than privileges guaranteed to Stroman; it is the single most important mechanism to recruit a broad enough set of clients to be successful at elections.

Can such a system still be called “capitalist”? Of course, it can. Our explanation is that the illiberal project cannot bring the whole economy under government control. Illiberal leaders need multinational capital; thus, multinationals are treated extremely well. And there is also a domestic sector of the economy, which remains competitive, where wages and profits are

<sup>1</sup> See a full list of the above-mentioned 18 illiberal national parties and their results in the recent elections between 2015-2018. Önis – Kutlay (2019).

generated on the free market. In 2019, for instance, the third-wealthiest Hungarian individual was Mr. György Gattyán, who made almost \$1 billion by opening a globally accessible sex website – the money he made was pure profit, not rent.

In fact, we are now back to the Weber – Fukuyama - Zakaria - Orbán controversy. Indeed, liberalism does assume the freedom of individuals, free competition, and the rule of law. Hence, capitalism can flourish only under “legal rational authority” – i.e., liberalism. This is the key message of Weber. Fukuyama, a bit naively, believed that the worldwide expansion of capitalism (and defeat of communism) would also produce liberal democracy. His mentor Huntington (1993) and Ken Jowitt (1993) were more careful, they both expected ethnic conflicts to overtake the ideological differences between capitalism and communism, without becoming liberal democracies. Zakaria, in contrast, saw the emergence of strong leaders, who rejected the “paralyzing” effects of the liberal division of powers.

The bottom line of our analysis is this: with 1989-91 communism as a worldwide challenge to capitalism ceased to exist, but especially after 2005, there is a trend towards illiberalism, strong executive in combination with electoral legitimacy. But no matter how you call it, what is important is to see that elections do matter in the illiberal regimes, hence executives pay a great deal of attention that they win elections (even if it requires manipulation of electoral rules, or if necessary, cheating at elections<sup>1)</sup>).

## *II. Re-conceptualizing modern capitalism with a new theory of rent*

Authors like Fukuyama (1989) or Sachs (2005) stayed within the customary dichotomy of the 18<sup>th</sup> and 19<sup>th</sup> century political economy models. Profit and wage formation explained the materialization of income and wealth and the road that eventually led to liberal democracy. In our recently published book (Mihályi – Szelenyi, 2019), we took the position that this is not sufficient to explain the economic dynamism and the global conversion toward Western liberal democracy.

While Adam Smith ([1776]1976) was arguably the first economist who identified *wages, profits*, and *rents* as the sources of national wealth, he had some skepticism of how much contribution rent made to wealth. In his words:

*„as long as land in any country has become private property then landowners love to reap where they have not sown and demand a rent for its natural produce”* (p. 56).

This foreshadowed the notion of rent as „unearned income”, later elaborated by Gordon Tullock (1967), Anne Krueger (1974) and Aage Sørensen (2000). While rent and rent-seeking are present in all capitalist societies, understanding how significant they are can be helpful to make a distinction among the three versions of modern capitalism (liberalism, illiberalism and dictatorship), as we discussed in the first part of this chapter.

<sup>1</sup> See e.g. „Hungary: Election Was Free but Not Entirely Fair, Observers Say”, *The New York Times*, April 9, 2018; “Opinion: Istanbul election re-do is a death knell for democracy”, *Deutsche Welle*, <https://www.dw.com/en/opinion-istanbul-election-re-do-is-a-death-knell-for-democracy/a-48627192>. Last time visited, February 18, 2020.

The classical doubts about profits, wages and rent as equally reasonable and justifiable components of the wealth of nation or new value can be traced back to David Ricardo (1772–1823). As Ricardo ([1871] 22004) astutely put it: “[Rent] is symptom, but is never the cause of wealth” (p.40). Rent, after all, is unearned income. Interestingly, Marx did not get this point and spent most of the unpublished Volume III of Capital challenging Ricardo and tried to prove that rent was just another form of profit. Since he could not accept profit – even if earned on competitive markets – for him the difference between profits and didn't seem to be interesting.

But what is rent? It is indeed a slippery concept. It may mean what you collect as a pensioner or your expenses on the house you rent from someone else, but it may imply an income you receive „unearned”, because you have monopolistic ownership of a significant means of production. Here we follow Sørensen (2000) insightful definition. Sorensen defined as “rent” payments that exceed the competitive price or the price sufficient to cover costs: “*the existence of rent depends on the ability of the owner of the asset to control the supply*” (p. 1536). We find this clear and persuasive.

As we elaborated at greater length elsewhere (Mihályi-Szelenyi 2016, 2019) there are rents, which have a positive effect on social and economic development. “Solidarity rent” enhances social stability, innovations usually need guaranteed “rent” (intellectual property right), too. But rents coming from monopoly or oligopoly – while they can boost development for while – like oil in the case of the Gulf Monarchies, they may be doubtfully sustainable. With the help of three similarly constructed tables below (TABLES 1-3), we make an attempt to apply our rent-based approach to different types of capitalist systems by distinguishing among three sources of income.

Table 1: Varieties of capitalism

1. LIBERAL CAPITALISM		
Profits and wages	Rents	Reciprocity
+++	++	+
2. ILLIBERAL CAPITALISM		
Profits and wages	Rents	Reciprocity
++	+++	+

Table 1 makes a distinction between liberal and illiberal capitalist systems. Liberal systems, be they entirely free markets, corporatist, conservative or social democratic, all include some state intervention to correct the so-called “market failures”. Their incomes (and wealth) come primarily from reasonably free market competition, earned profits and wages (denoted with +++). In illiberal systems, there is some, but proportionally smaller (++) income and profit generated on free markets, and politics often intervenes into market competition in order to enrich political bosses and their families or to create a clientelistic “national bourgeoisie”. As we know from Karl Polanyi (1957), reciprocity played a crucial and occasionally

a primary role in ancient economies. No modern macro-economic system is integrated by reciprocity, but in household economies, reciprocity can still be important.

Table 2: Varieties of liberal capitalism

A. FREE LIBERAL MARKET ECONOMIES		
Profits and wages from free market competition	Rents/ income transfers by state welfare redistribution	Family based reciprocity
+++	+	+
B. COORDINATED MARKET ECONOMIES: SOCIAL DEMOCRATIC SYSTEMS		
Profits and wages from free market competition	Rents/ income transfers by state welfare redistribution	Family based reciprocity
+++	++	+
C. COORDINATED MARKET ECONOMIES: CORPORATIST SYSTEM		
Profits and wages from free market competition	Rents/ income transfers by state welfare redistribution	Family based reciprocity
+++	+	++

Table 3 offers some hypotheses about three types of liberal capitalist systems. There are, of course, no “totally free market economies”, but the US comes the closest to this ideal typical model. Ronald Reagan’s famous statement, “the state is not the solution; the state is the problem”, is a reflection of this ideology. But, of course, even under Reagan, there were progressive income (and profit) taxes and massive subsidies through social security. In addition, there were substantial welfare payments for the poorest of the poor. The social democratic type regimes have more state intervention (++) , usually higher taxes and often universal insurance system, which offers everyone, on citizenship rights, the same benefits, without means testing. The corporatist systems tend to be more “targeted” in their social policy; they support families in poverty rather than individuals. There are no strict boundaries between the three systems. During the 1960s the US came close to the social democratic paradigm and given the pressures of globalization (capital flight) Scandinavia is not quite like as it used to be 20 years ago. Under Thatcher, the UK became closer to the US, but many of its social democratic features survive (like the health care system, the NHS). So, there is no “good liberal capitalism” or “bad liberal capitalism”, actually existing capitalisms fluctuate between the various versions.

The common features of all liberal forms are that they are committed to the ideals of liberal democracy, rule of law, separation of powers, free media, and fair and free elections. How deep these commitments are varies from country to country. Donald Trump, for instance, is an illiberal politician. He challenges the authority of Congress and attacks the courts, much like Viktor Orbán does in Hungary. Ethno-nationalism is strong not only in the US, but also in the UK, but even in Finland, Sweden, Austria (and of course in Hungary and Poland).

Table 3: Varieties of illiberalism: soft and hard versions

ILLIBERAL MARKET CAPITALISM (SOFT VERSION)		
Profits and wages from free market competition	Rents/ income transfers by state welfare redistribution	Family based reciprocity
++	++	+
ILLIBERAL SYSTEMS, WITH DICTATORIAL TENDENCIES (HARD VERSION)		
Profits and wages from free market competition	Rents/ income transfers by state welfare redistribution	Family based reciprocity
++	++	+++

For Weberians, the most surprising new development is the success of capitalist development in countries that do not know the legal-rational authority. OK, capitalism can work without democracy; that is no surprise, but how can it operate without a predictable system of law, an independent judiciary, and a legislature?

As we have already stated above, the essence of illiberalism is the weakening of the separation of powers and the strengthening of the executive branch. It is supported by a desire for strong leadership and the defence of national identity. These are both vote-winners and can easily give strong representation in the legislature (even two-thirds majorities). This is working relatively well in established democracies, like the Brexit vote in Britain and the anticipated 2020 victory of Trump in the US. Unsurprisingly, illiberalism and even dictatorships often appeal to a very large part of voters (not a 50% majority, though) in post-communist countries, without much or any democratic past and a deeply rooted nostalgia for strong leaders.

Just to return to Weber: in illiberal systems, there is still some room for liberal capitalism and competition, hence room for capitalism. This is less the case in capitalist illiberal dictatorships, where there is no separation of powers and the source of law is the ruler (prime examples are the United Arab Emirates or Saudi Arabia). Nevertheless, both are well-functioning capitalist economies.

So, was Weber wrong? Today it seems to us that he might have overemphasized the need for legal rational authority, but we are convinced that illiberal systems and dictatorships do have essential, vulnerable points. One is, of course, the question of succession. The leaders of these countries do not like their possible successors. President Xi eliminated the term limit carved in the Chinese constitution in 2018; Putin went in the same direction in early 2020, when the whole world was occupied with the coronavirus crisis. Donald Trump may dream about a “dynasty” and turning his illiberalism into an absolute monarchy, just like his beloved Saudi Arabia.

But let us not end this essay on a negative note. If we take the long-run view, we have a robust argument for being optimistic. As Zakaria (2007) noted, at the beginning of the 20<sup>th</sup> century

there were no free countries on Earth meeting the standards of today: universal suffrage was limited everywhere to some extent. According to the Freedom House metrics, in 2018 the number of free countries stood at 85.

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## 11. Moral Panic against Globalization

### *Introductory remarks on moral panic<sup>1</sup>*

The basic meaning of the Greek word for panic is disproportionate, exaggerated fear of a phenomenon that is encountered unexpectedly and simultaneously by a large group of people. It is partly genetically encoded and partly a learned response in all humans. The problem of moral panic has only been of concern to sociologists and political scientists since the 1960s, but it is as old as humanity itself. Moral panic occurs when people become aware of an unexpected and widespread disaster threatening the idealized order of the society they live in: people desperately look for scapegoats and/or blame themselves for the experienced disaster. The Old Testament is full of such deliberately frightening, instructive stories. Consider, for example, the passages about the fate of Sodom and Gomorrah (*Genesis 1, Ch. 18-19*), which God destroyed because of their grave sins, such as adultery, pridefulness, and absence of charitableness. The Sodom-Gomorrah example is a good starting point because of its draconian outcome. With one exception – namely, the family of Lot – all the inhabitants of the two kingdoms were deadly punished. But in the vast majority of cases, moral panic arises among *the directly affected people who learn about a disaster from others who are not affected*.

The main hypothesis of our study is that in the third decade of the 21st century, we are facing three major challenges.

- the coronavirus pandemic (COVID-19), the end of which we still don't see,
- the conflicts of demography and economic growth, in its own ways, both in the developed and the underdeveloped countries, and
- the unfolding environmental emergencies.

Opinions differ on the causal links between the three issues and their combined impact, which is visibly destabilizing the global world order. Some believe that the economic problems and the breakdown of the global order are the result of the pandemic caused by the new coronavirus. Others believe that the pandemic, the economic meltdown, and climate change are also the results of globalization, so *the moral panic is directed against globalization as such*.

### *The origins*

In the context we use it, the concept of moral panic was first applied by Marshall McLuhan in 1964. In his pop-cult book, McLuhan wrote about the narcotic effect of the media. Although McLuhan was not the first discoverer of *fake news*, he argued that the media is in fact, an extension of the personality. Following the Hungarian Marxist philosopher György Lukács (1885-1971), his thought process can be interpreted in the sense that the media objectify and

<sup>1</sup> First published in *International Political Anthropology (IPA)*, 2022. Vol. 15. No. 1. IPA is a peer-reviewed journal, edited by The International Political Anthropology Association, Department of Political and Social Sciences (DiSPeS), Università degli Studi di Trieste.

de-objectify the personality, and through this, exert pressure on the personality. To put it simply: the media do not lie but exaggerate and thereby reinforce moral panic.

McLuhan had a huge impact on young social scientists. An important consequence of this was the understanding of deviance as a social construct, which is still valid today. Who is deviant and which behavior is deviant cannot be objectively defined but is formed in the course of social conflicts. In Islam, sex outside of marriage is a serious crime - in some countries, even punishable by death - but in contemporary Christian culture, it is at most a forgivable sin, or, if the partners are not cheating on their partner, there is no moral judgment attached to it. But even in Christian culture, this was not always the case! It was not so long ago that an unmarried girl who became pregnant had to jump into the well to avoid shame for her and her family.

From the beginning, there was also an objectivist (Marxist, or at least positivist) interpretation of moral panic. An early and forceful formulation of this was provided by Stuart Hall, a major social scientist of the time (Stuart Hall, 1978, and see also Stanley Cohen 1973). In their view, moral crises are created by specific actors for their own very real interests. Hall, following Antonio Gramsci (1891-1937), saw in the moral panic the phenomenon of bourgeois hegemony, generated by the state and magnified by the media.

### ***Example 1: Clacton (UK).***

In 1964, the very year McLuhan's book was published, a small town in England, Clacton, had a very rainy Eastern, which disappointed the young people who were looking forward to Spring. Bored, they started rioting in the high street, which turned out to be wilder than the young people would have liked. The story - "What are today's English youth like?", "where have the English lost their ancient morals?" - was picked up by the press. All the important elements of moral panic were in the story. The media presented a local issue as a national issue. It wasn't *fake news* - young people in Clacton were indeed rioting. It was possible to detect an identifiable enemy, young people whose morality is shaken, who are worth fearing, and if you meet them after that night, you'd better avoid them and cross the street. The enemies are the others, the unknown, who are therefore particularly dangerous.

### ***Example 2: The Central Park Jogger***

Although initially, the phenomenon of moral panic was used only to describe the rioting of young people and then criminals (and soon drugs), it was extended over time to a wider range of phenomena and actors. The creation of moral panic proved particularly explosive when the media managed to present social problems as "ethnic" one and even mix in some sex (as in the Biblical example cited above). The story of the Central Park Jogger is such a classic example from the recent past.

At 8 pm on 19 April 1989, a well-off, clearly upper-middle-class, pretty lady working on Wall Street, Ms. Trisha Meili, went for a run in Central Park. She was horribly assaulted, raped,

and suffered a life-threatening head injury. She was hospitalized, and although she managed to survive, it took six weeks to regain consciousness. But she remembered nothing. Her story became a huge national media sensation, especially after police arrested four young black and one Latino youth. Their names have become known as the “*Central Park Five*”. The police were quick. Arrests were made two days after the attack, and four days later, the names of the five suspects were released - illegally because some of them were under 16. Donald Trump, who was already a well-known personality at the time, issued a statement condemning this attack on a white American woman long before the trial and then called for death sentences in a paid advertisement. In the end, the alleged perpetrators received prison sentences of 5-12 years.<sup>1</sup> Much later, however, a totally different person, a man sentenced to life imprisonment for multiple rapes, Matias Reyes, confessed to raping Trisha Meili. Eventually, in 2002, a court acquitted the five then not-so-young men of the original charges.

The 1989 media campaign in the immediate aftermath of the Central Park crime was a classic case of moral panic, as in the UK example above. During the 1980s, the ethnic conflict in New York was already high, leading to the white majority’s fear of blacks. Many people were afraid to ride the subway, preferring to take taxis. Many people tried to avoid the streets as much as possible, and there were white women who, when confronted by a black man after sunset, would cross the street. The racism of the moral panic around the issue was first authentically reported to the general public in the 2019 film *When They See Us*.

### *Moral panic generated by immigration*

The history of humanity is a history of migrations. It has sometimes been bloody and murderous, with one ethnic group trying to make a place for itself by exterminating the inhabitants of the invaded territory; however, there were also many examples of amalgamation before the emergence of the modern ethnically homogeneous nation-state. Premodern societies were typically multi-ethnic, multilingual - in today’s terms: multicultural - systems. Such was France before the revolution of 1789, or the Austro-Hungarian monarchy before 1918.

After the emergence of linguistically, ethnically, and often religiously homogeneous nation-states, immigrants who did not speak the language of the majority or differed in the other two dimensions repeatedly aroused resentment from the majority. This often led even to genocide. The greatest of these genocides were often against the “enemy within”, who had lived with the majority, who opposed them for an infinite duration of time, or at least for centuries or decades. The most dramatic case was the Nazi Holocaust, driven by the weird beliefs of a single maniac, namely Adolf Hitler. There are other aggressive nation-builders, for instance, Prime Minister Narendra Modi in India, who has tried to create a country with

<sup>1</sup> Unfortunately, in the American justice system, it is not uncommon for innocent people to admit their “guilt”. The institution of the plea bargain plays a big role in this. This was not the case with the *Central Park Five*. During their interrogation, the young people were tortured, they said they were not allowed to sleep, and they were not fed.

one language and one ethnicity with brutal measures since 2014.<sup>1</sup> Similar but less personally driven was the case with the genocide of Armenians in Turkey, the massacre of Tutsis in Rwanda and Burundi in Africa, most recently the mass killing of Rohingya in Myanmar, and the prosecution of Uyghurs in Western China.

In addition, the demographic explosion occurs in areas of the world already experiencing high levels of poverty, which will be hardest hit by climate change: rising sea levels, spreading deserts, and deteriorating land quality. Add to this the fact that it is in these regions that murderous civil wars are being waged. Many of these are being instigated and financed by the central countries of the world system, especially the USA, but of course, neither China nor Russia is innocent, and the Soviet Union was also very active in generating such conflicts at the time. People are also fleeing poverty, like the guest workers in the Middle East (Szelenyi, 2018) or escaping religious fundamentalism and tribal conflicts. Afghanistan is the most tragic example being to a 20-year-long unsuccessful attempt by the US to turn this country into a secular and tolerant country.

### *Example 3: The 2015 European refugee crisis*

Fear of migrants in Europe significantly preceded the refugee crisis during the hot summer weeks of 2015. One important theatre of this was England, which had previously been remarkably open, given its global imperial ambitions and commitment. In the early years of the 21st century, it was not primarily immigrants from India, the Middle East, or Africa who were “responsible” for the panic<sup>2</sup>, but citizens of the enlarged European Union. After 2004, immigrants from Eastern Europe were able to move to the UK and work there as a result of the EU membership. The main object of fear was not the Roma, who are easily distinguishable at a glance from Romanians, Hungarians, or Bulgarians, but the stereotypical “Polish plumber”.<sup>3</sup>

On 7 January 2015, a horrific terrorist attack took place in Paris. The French magazine *Charlie Hebdo* was attacked by Islamist terrorists over a cartoon mocking the Prophet Mohammed, killing 12 people. There was a huge outcry in Europe, and on 11 January, European democrats expressed their feelings against terrorism in a huge demonstration. While it was a noble act, it already set the stage for “anti-Islam, anti-migrant” discourse, which appealed to many on the far right, including Viktor Orbán in Hungary, Matteo Salvini in Italy and the nationalist, right-wing populist party in Germany (*Alternative für Deutschland*, AfD). There was an identifiable enemy, the “migrants”: not “immigrants” or “settlers”. Moreover, now the migrants were “different”. Muslims - and Islam is seen by many as a threat to white, Christian (or in slightly racist terms, Judeo-Christian) culture. The “migrants” were presented as an

1 There is a promising and refreshing exception, namely Switzerland, but that is a small, inward-looking, rich country with an exceptionally long history of multi-ethnic institutional structures.

2 The Mayor of London in 2020 was Sadiq Khan, a Muslim born to Pakistani parents. There is considerable Islamophobia in England and even in London 31% of Londoners did not want a Muslim mayor (according to a Yougov poll), yet Khan won the mayoral election in 2016 by more than 50%

3 According to Wikipedia, the Polish plumber metaphor first appeared in a 2004 article of the French satirical weekly *Charlie Hebdo*, to which we shall refer one more time in this paper for a different reason.

existential threat, taking local jobs, raping their wives or daughters, at least according to the hourly plastic media reports. And this has also happened in other continents, think Brazil (Bolsonaro) or India (Modi).

In 2015, the European Union was unprepared for the 1 million or so Middle Easterners who would be heading for the Mediterranean. Some reached European shores, some drowned, but the real moral panic was caused by a photograph of a three-year-old boy. Kurdish-born Alan Kurdi, born in Syria, drowned at sea on 2 September 2015. His body was discovered by photojournalists on the Greek coast. Their photographs shocked Europe's conscience.<sup>1</sup>

By way of comparison, in the Vietnam War, the moral reversal was similarly triggered by a shocking photograph. On June 8, 1972, the South Vietnamese army launched a napalm attack on a suspected guerrilla group, but most of the victims were civilians and children. A journalist took a shocking photo (which, after much hesitation, was published in the *New York Times*) of 9-year-old Kim Phuc, who was running naked with several children to escape the napalm attack. As it turned out, the little girl suffered severe burns but did not die, and after 10 years of medical treatment, she was able to resume a normal life.

A dramatic photo or live video reporting can therefore have consequences for world politics, positive or negative, depending on the reader's own moral position. The image of Kim Phuc fleeing naked from napalm played an important role in the US abandoning the war in Vietnam. The photograph of Alan Kurdi's body on a Greek beach had a decisive influence on Angela Merkel, the daughter of a Lutheran pastor, when she saw a crowd of people on 4 September 2015 at Budapest's Eastern Railway Station, ready to leave on foot for the West. This was the moment when she famously said: Germany will accept all refugees. Merkel was a particularly sober and pragmatic politician. She must have been aware that by making this statement, she was taking a huge risk, perhaps committing political suicide. Yet, initially, her decision led to a huge surge in popularity. The data showed that the quick integration of refugees was difficult, but not impossible, in Germany. This was hailed as a failure by the right and a success by the liberals. Nevertheless, at the start of the next refugee crisis (the one after the Taliban takeover in 2021 in Afghanistan), the German response has been much less generous, although the illustrated news reports from Kabul airport during the last days of NATO presence were very influential on Western policymakers once again.

This is interesting for several reasons. It shows that moral panic is not simply racism, as in the *Central Park Five* story, or religious prejudice against Muslims. The panic can also have a completely rational, existential basis, such as fear for the workplace. However, if Roma girls take jobs in brothels (of which there are several examples), that doesn't bother the English middle class. If African immigrants clean their sick mothers, which no English worker would apply for, there's nothing wrong with that either. The Polish plumber, on the other hand, works cheaper than the English (male) competitor - that is what is "unacceptable". Overgeneralizing this rational core can lead to disastrous consequences. Brexit, Britain's exit from the European Union, is a case in point. According to all preliminary estimates, the British lower-middle class will lose many more jobs after Brexit than Polish plumbers

<sup>1</sup> The pictures are, of course, available on the web. See [https://www.wikiwand.com/en/Nil%C3%BCfer\\_Demir](https://www.wikiwand.com/en/Nil%C3%BCfer_Demir)

were previously feared to occupy. This is the very essence of moral panic: a realistic threat appears greater out of context than it is in reality, but then hasty policy responses can cause greater damage than the original - real - but exaggerated - threat itself.

### *Example 4: Donald Trump and the Mexicans' invasion*

The ethno-nationalist, anti-globalist ideology has also proved to be a winning political ideology in the United States, supposedly the most open country in the world to "others". On 16 June 2015, Trump announced in his own company's New York office building that he was running for the Republican Party's presidential nomination. Trump's presidential aspirations were no surprise; he had indicated for some time that being just a real estate investor and TV star was not enough for him.

More relevant to our subject, however, are Trump's statements of 16 June 2015. At the heart of the speech, and the most important message of Trump's subsequent victory, was his stance on Mexican and South American immigrants in general. Although Trump acknowledged that there are "some decent people" among Mexican immigrants, he tended to emphasize that Mexico sends to America those with problems: drug addicts, criminals and rapists. Trump promised that if elected president, he would protect 'American culture' (he didn't say it like that, but he clearly meant the white, European culture that once made America 'great') and American jobs. Trump promised to build a wall on the US-Mexican border. There was nothing shockingly new in this; the US had already been fortifying the Mexican border for some time, not to mention Israel, where there were major walls to keep Palestinians out of the way of Jews.

Trump and the European anti-migrant fighters played from the same sheet music, and both got what they wanted. The enemies were different, but their characteristics were similar. Trump fought with Mexicans and only mentioned Middle Eastern immigrants in passing. In Europe, the main enemies were refugees from the Islamic world. They argue their mission is to defend ethnically white, Christian Europe.

Trump was in a more difficult position. The United States is ethnically a very diverse society. According to the 2010 census, whites of non-South American origin made up only 61% which shrank to 58% by the most recent census of the population, and given the lower fertility rates, some projections suggest that by 2045, 'true' whites will be a minority of the population.<sup>1</sup> For Trump, the anxiety of "true whites" that they will soon be a minority was extremely important. Obama's election as president was a warning sign for many about the future of whites. Around 2010, a significant white nationalist movement, commonly referred to as the *alt-right*, began.<sup>2</sup> It has included proto-Nazi movements, but also white nationalists – though

1 Ethnicity in the US is not a simple issue. Whites who have immigrated from Mexico or South America are not necessarily accepted as white. For this reason, statisticians distinguish between two categories of white 'race': *Hispanic whites* and *non-Hispanic whites*. Similarly, blacks from the Caribbean islands are not necessarily accepted as African American by blacks in the US. All this is strong social science evidence that ethnicity is not a biological endowment but a social construct.

2 In this expression, the word "alt" stands for "alternative". An important feature of the alternative right is its extensive use of the internet and, within that, social media.

not necessarily extremists - who were concerned about America's white culture, so the *alt-right* can integrate many shades of the right. Of particular importance was *Breitbart News*, which was taken over by Steve Bannon after the death of founder Andrew Breitbart in 2012. But if immigration is stopped, as Donald Trump, while president, so badly wanted, the US will be one of the countries with a declining population. Nevertheless, the loss of an ethnic majority, or perhaps a majority position, is a cause for panic, which for many exceeds the negative economic consequences of an ageing and shrinking population.

There is little doubt that without *Breitbart News* and Steve Bannon, Trump would not have won the 2016 election. Trump needed the vote of white-Christian Americans who felt threatened in their identity – regardless of whether or not Trump himself was an extreme white Christian nationalist. Bannon was a leading figure in the Trump campaign, and in gratitude for that, he was appointed by Trump as his chief adviser after his election. Bannon was allowed to stay in this key position for 7 months. In his strong moral panic against immigrant Mexicans, drug smugglers and criminals, and rapists, Bannon was a help. When the Moor had done his duty, the Moor could go. Trump had new issues to deal with: Islam, ISIS, the Chinese, the Russian involvement in the US election campaign, etc. Bannon's new job was to unite the European right. He recognized in Salvini and Orbán the "greatest politicians" of Europe. He visited them both, and even moved to Rome for a while, and really tried to create what we called in an earlier article (Mihályi – Szelenyi, 2018) the Illiberal International. And he almost succeeded until Christian Strache, the leader of the far-right Austrian populist party (FPÖ), had the misfortune to be caught up in a corruption and sex scandal linked to Russians in Ibiza. Despite all this, Trump has since been using new variations of moral scaremongering, and not without success. And he seemed to be on his way to be reelected in November 2020 (and indeed he was close to it).

### *Example 5: The panic about Afghanistan*

In November 2020, Joe Biden did beat in the popular vote Trump, but received a tiny majority in the House and the Senate. Given his relative weakness in the legislature, by and large, he must follow Trump's immigration policy.

He also followed Trump's policies on Afghanistan. It seems that Trump and Biden might have been right that it was time for the US to finish the two-decade-long unsuccessful war in Afghanistan, but none of them expected the sudden collapse of the pro-American Afghan government. They expected this government to keep control for a few years or at least a few months. But the Taliban took control of Kabul within a few days, creating a sudden moral panic among conservatives and liberals worldwide, as it became clear that US, UK, and other Western citizens were left behind, not speaking of Afghans who had collaborated with the Western powers and had reason to fear punishment by the Taliban. While the US rescued some 120,000 civilians, the troops left hundreds of thousands of Afghans at the mercy of the Taliban. The televised chaos at Kabul airport and the ambiguous reaction of Western powers, whether they will accept enough Afghan refugees, increased the moral panic manyfold.

### *3. The most devastating epidemics of our time, and the scale and nature of the associated moral panics*

Based on the evolution of the coronavirus epidemic so far, we formulated two hypotheses.

1. Europe and the USA, the upper-middle class of the world, became the epicenter of the COVID-19 pandemic; this made the moral panic particularly intense.
2. Since this epidemic affected the most privileged strata (classes?) of the world, the measures taken to combat it (e.g., the lockdowns in certain economic sectors) hit the broadly defined working class and the poor hardest, not to mention the workers on the periphery, even in developed countries.

Epidemics have never stopped at the borders of countries or empires. In some cases, a quarter of humanity was wiped out. The worst such epidemic was the plague of the 14<sup>th</sup> century. This was also thought to have come from the East (perhaps China?). The Tartars carried it into Crimea, and from there, it spread to Europe and then North America via maritime connections. It certainly hit Europe the hardest between 1347 and 1361, i.e., for 14 (!) years. It killed at least 100 million people.<sup>1</sup> So it was very much a *pandemic*, shrinking the world population from 475 million to around 356-375 million, and it took 200 years for mankind to return to its previous peak. Before we explore the specificities of the present coronavirus pandemic, we will analyze three historical examples from the last 80 years: AIDS, TB, and malaria.<sup>2</sup>

#### *Examples 6-8: AIDS, tuberculosis, and malaria*

*Aids.* The illness from acquired immune deficiency syndrome (AIDS) was one of the biggest pandemics of our time and remains so today. In 2020, 38 million people globally were living with AIDS caused by the human immunodeficiency virus (HIV) infection. In that year, 1.5 million people became newly infected, and 0.7 million died from AIDS-related illnesses.

The AIDS epidemic exploded in the United States: between 1981 and 2000, around 50,000 people died from the disease each year, but only a third of these were white; African Americans and Hispanics were the main victims. In Africa and South-East Asia, AIDS became the leading cause of death. The spread of AIDS was dramatic. The first AIDS death was reported in the New York Times on 3 July 1981. At that time, 26 deaths were reported, rising to 159 by the end of the year. As the disease escalated into a pandemic, the death toll exploded, rising to between 2-3 million a year in the peak years (2000-2004). In the beginning, the HIV was particularly deadly, and anyone infected with HIV was very unlikely to avoid AIDS and death, which usually meant terrible suffering. The victims often included some of the most prominent figures in the scientific and cultural world. We have seen/read many shocking media reports about them.

<sup>1</sup> Some estimate the death toll from the 14<sup>th</sup>-century plague at 200 million. Plague epidemics continued to ravage later centuries, but the disease has still not been completely eradicated.

<sup>2</sup> Since 1940, there have been around 350 global epidemics, including several with millions of victims. See *Der Spiegel*, 18 April 2020.

The clear association of the disease with homosexuality certainly played a role in the fact that AIDS was not seen by many as a common threat. It is a “gay disease”, many people thought. The group at risk was not society in general, but a subset of what many already considered to be “immoral”. This was not true, of course, because AIDS was spreading among injecting drug users, bisexual men were infecting women, and even the children of infected mothers were being infected. The AIDS narrative was partly rooted in the biblical story of Sodom and Gomorrah, already referred to above. AIDS was considered by many as God’s punishment for “sinners” who would have done better to abstain from sin or at least have “safe” sexual relations in monogamous relationships (and use a new needle if they were drug addicts).

Although AIDS was a good story for the media and we could scare people about “what is not happening and how to be careful”, it is a fact that countries have spent huge sums of money on treating the disease. At the end, the AIDS pandemic did not have a devastating economic impact, at least outside Africa, and politicians - except for South Africa - have not used the opportunity to maximize their power. In general, AIDS was not criminalized, there was no curfew, and even bars frequented by gays were not closed. Baths frequented by gays were closed, not by official decree but because of declining solvent demand. There was hardly any quarantine either.

It is striking that the AIDS epidemic seems to have been forgotten by the media by now, even though its devastation was on a par with that of the coronavirus. There is still no 100% sure cure for AIDS and no vaccine. Certainly, the striking decline in awareness is partly due to the epicenter of the epidemic shifting from developed countries to Africa and South Asia, from “whites” to people of color.

*Tuberculosis (TB).* TB has been known since antiquity, but it was not identified as a widespread disease in Europe and North America until the 19<sup>th</sup> century, and it was not until 1880 that it was confirmed as a communicable disease. At that time, it was also called the “white death” or “white plague”. Antibiotics have been used to cure TB since 1946, and the well-known BCG vaccine can immunize people for life against the disease. Despite this, TB infections occasionally occur even among those who have already been immunized. As far as humanity as a whole is concerned, TB continues to be a devastating epidemic, with 1.4 million deaths in 2019 and around 10 million cases annually.<sup>1</sup> As with AIDS, the epicenter of TB has shifted, with 95% of deaths occurring in peripheral countries of the world system, mainly in Africa and South-East Asia. The practice of quarantine, if never on the scale of the coronavirus today, was well known. Since in the first half of the 20th century, most TB-infected people were considered by doctors to be “doomed”, there was a more or less forced effort to isolate all infected people in pulmonary sanatoria.

Today, however, there is no moral panic about TB, the main reason being that, despite the devastating mortality rate, the disease is curable, and the situation is improving in almost all

<sup>1</sup> Due to its infectious nature, TB continues to be somewhat stigmatized, so both the number of cases and deaths are likely to be underestimated.

countries year on year.<sup>1</sup> But perhaps the fact that “white deaths” have become “black deaths” also plays a role. Most TB deaths occur in the poorest countries, where malnutrition is the main cause (particularly affecting children). The notable exception is Russia, where, like other diseases, alcohol is the main cause of TB deaths.

*Malaria.* It is the least deadly and least global infectious disease on our list. Although the number of people infected exceeded all other epidemics (229 million people!), the number of deaths was only 409 thousand, much fewer than the number of victims COVID-19 claimed by the end of 2021. Malaria is also a global pandemic: it is ravaging 91 countries, but 85% of infections are concentrated in 20 countries. Around 90% of malaria deaths are in Africa, and 67% are children under 5 years old. Malaria is therefore mainly a killer of African children, and it is no coincidence that it does not receive much international media attention. The good news is that effective anti-malaria drugs are now available - the question is who gets them and at what cost.

### *Example 9: The COVID-19 pandemic*

As is well-known, COVID-19 unexpectedly broke out at the turn of 2019/2020. The three examples of the well-known “older” pandemics were different in three ways.

- (i) The old diseases are now only really devastating in the periphery of the global economy.
- (ii) The demographics is different. While the average age of those who die from coronavirus is in the late 70s, people living with AIDS are often young people aged 20 to 30. TB and malaria have always caused many fatalities under the age of 5. COVID-19 was completely new, and for a while, it was also “white” disease.
- (iii) The other epidemics are on the decline and there are drugs for them. In contrast, scientists are still looking for a cure for the coronavirus disease.

This is why the SARS-Cov-2 virus, brought to humanity, in Donald Trump’s phrase, by an “invisible enemy”, was particularly frightening. This invisible enemy can be our own grandchild (who brings the infection home from nursery school), or it can be the fingerprint on the letter in our letterbox. Or, at least, so it was told by the media at the outset of the pandemic.

The recorded number of COVID-19 deaths is above 6 million people.<sup>2</sup> Some experts argue that the world was *underestimating* the devastating power of the epidemic. Some people die of coronavirus in their homes who are not even registered as victims of the virus (they think they were just unlucky flu victims or simply very old). There must be some truth in this. But other experts assert that the death figures attributed to the coronavirus are vastly *overestimated*. Perhaps we are not unreasonably suspicious when we think of someone who died in a hospital and was known to be infected by the virus, would have died anyway due to their fragile health status and/or comorbidities.

1 One of the main claims of Susan Sontag’s 1978 book (*Illness as Metaphor*) was that moral panics around TB had been operating for centuries and were still operating. In her writing, she challenged the victim-blaming in the language that was often used in the 19<sup>th</sup> century to describe various diseases (including cancer!) and the people affected by them.

2 At the time of the final submission of the present paper.

In terms of the *number of infected people*, we are in even bigger trouble. These data are almost useless. The testing for viral infection varies widely from country to country, as does the reliability of testing equipment and measurement indicators. But perhaps we are not far from empirical reality when we say that those who have been tested are those who have had severe symptoms or at least personal contact with infected people. You can't test 8 billion people, but the serious consequence of doing so is that those declared infected will be over-represented in severe cases and will not include enough young and healthy people who were affected by the virus as "flu-like" and immediately became immune to COVID-19.

What is crucial: no rational policy decision can be made without knowing the exact ratio of infected to dead in COVID-19.<sup>1</sup> Some experts estimate it between 0.2-0.3 and 10+ %. It would be up to epidemiologists to give us more accurate information on this (and perhaps social scientists could help us with this, so that we have something to say to increase our own "class power").

The main arguments of the moral panic associated with COVID-19 are:

- (i) The epidemic is a consequence of globalization. Not everything should be imported from China, just because it is cheaper. We should not consume so much, travel so much, and be so touristy.
- (ii) The epidemic is spreading because people do not follow simple hygienic rules: social distancing, the use of masks, and frequent handwashing. If you get infected, blame yourself.
- (iii) Governments (especially the EU) have made mistakes: they have not purchased enough protective equipment, testing equipment, and ventilators in time. In almost all countries, nursing homes and hospitals were the epicenters of the epidemic. These institutions could have been protected if governments had been smart and early in the fight against the epidemic.
- (iv) People who also have other conditions - such as high blood pressure, diabetes, and pre-existing respiratory diseases - are more likely to get the disease, which is largely linked to a poor lifestyle. Again, blame yourself first.

The political dilemma is inhuman. Everyone should stay at home; all shops, offices and schools should close; GDP should fall by X %, unemployment and poverty should rise by Y %? How many lives are saved by this? Z number of people? And if most of the people who die are 70-90 years old and sick anyway, how much longer will we prolong their lives on average? Six months, 12 months? To put it brutally, is it worth it for an 84-year-old man, like one of the authors of this study, to live 6 months longer if the cost is 100,000 unemployed? There is no scientific answer to this terrible dilemma. It is a political decision. Politicians should decide on such matters based on good data but let us not allow them to pretend that science has decided for them.

To complicate matters further, we find huge differences between regions and countries. In general, we might think that the devastation is greater in larger cities, like Milan, Paris, or Madrid, New York, San Francisco seemed to show. But there was an increasing pandemic

1 In epidemiological jargon, this is the so-called Crude fatality ratio (CFR).

in far - away Asian cities, like Tokyo, Delhi, Baghdad, or Bangkok. Although the epidemic may have originated in Wuhan, China - this is still somewhat disputed - the fact is that, to the best of our knowledge, this pandemic has affected just to some extent Asia and spared, at least in its initial phases, Africa, even though the epicenter of epidemics for both AIDS and malaria and TB has shifted to these continents.

COVID-19 has been politicized to its roots. When every Democrat in the US Senate wore a mask and no Republican did, why should we believe that it is rational to discuss whether it is right to wear a mask or not? Donald Trump - while president - thought that the SARS-CoV-2 virus was just a Democrat ploy to undermine his presidency and the outbreak was merely a Democrat hysteria (*hoax*). After a while - too late for his re-election campaign -, he realized that it was more worthwhile for him to act as the nation's savior, so he became a big fan of shutdowns. But eventually, the plummeting economy and rising unemployment became more important than the number of people falling ill or even dying from the coronavirus. "Reopening the country" became the new watchword, but too late for Trump.

It would be convenient to argue that the 2015 refugee crisis explains the spread of the coronavirus. This argument, favored by many radical right-wing politicians, could be consistent with the higher Italian, Spanish, French and Belgian figures, but the argument collapses in the light of the Greek, German and Austrian figures. Donald Trump wanted to use his move to block immigration from Mexico as a public health defense, but it did not work; migrants were not more infected than Americans. The anti-Muslim, European illiberal right<sup>1</sup> was in similar trouble. The Middle East, at least so far, has not had a high number of fatalities.

But the most exciting, though most controversial, comparison would be between some Asian countries and developed Western countries, because of the less reliable data. Since the press is free in Japan, South Korea and Taiwan (which is not necessarily true for some of the Eastern European countries), these data deserve more attention, although we may have even more skepticism about the Chinese and Vietnamese figures.

#### *4. Dictatorships can prevent moral panic*

*Examples 10-12: Russia, China, and the illiberal regimes elsewhere*

One important technique to fight moral panic is to deny the danger and/or the existence of those incidents that threaten our order and safety. This is particularly common practice among dictatorial regimes (Mihályi – Szelenyi, 2020), but occasionally, there are similar examples even in liberal democracies. The classical example was the denial of a nuclear disaster in the USSR almost 70 years ago, and most recently, China's reluctant cooperation with the West in identifying the origins of the first COVID-19 infections in the mega-city of

<sup>1</sup> In this paper we make a distinction between „illiberal right and illiberal left”. Illiberalism implies a political/administrative where in contrast to liberal or conservative regimes the power of the executive branch is not effectively controlled by the legislature and the judiciary. The illiberal right claims to have a special affinity to the interest of the nation, and or ethnic, religious beliefs, the illiberal left makes similar claims to be the “party” (usually accepted as “communist”) of “subordinated” classes or other groups.

Wuhan with a population of 11 million inhabitants. This is possible when the media is under draconian political control and there are no whistleblowers to alarm public opinion.

Let us start again with history. It is well known that the Soviets launched the first *Sputnik* on 4 October 1957, causing a shock effect around the world, allegedly proving the superiority of central planning over market-based capitalism. It is less well known, however, that just a few days earlier, on 29 September, an unprecedented nuclear explosion occurred at the top-secret *Mayak* plutonium plant in the Siberian city of Chelyabinsk (now known as Ozyorsk). At least 6,000 people died as a direct result of the radiation, and possibly 4-5 times more in indirect ways. Although the Western press had already sniffed something in 1958, there was no proof. And the CIA, which had known about this industrial accident since 1959, remained silent for long time because it was protecting the interests of the US nuclear companies, who did not want to generate moral panic against nuclear science as such. It was therefore only in the second half of the 1970s, when the world – and at least a narrow circle of intellectuals in the Soviet Union – learned about this unprecedented disaster, after a Soviet dissident, Zhores Medvedev (1977, 1979) by then already living in London, published the irrefutable evidence. If all this had come to light back then in 1957, the *Sputnik* success could not have been presented for a single day as the superiority of Soviet science over the capitalist economy.<sup>1</sup>

The situation about the uncertainty of the first human SARS-CoV-2 infections in China is very similar to the Russian case. At the turn of 2020/2021, China was widely celebrated in all parts of the world, as a country where the scientific community was at par with the most developed countries and a political system that was capable of eradicating the virus almost entirely in 76 days (Sha, 2020). After all, Chinese scientists isolated the new virus first, and they were also fast in developing a vaccine against the disease. But if and when the WHO and the world's scientific community prove with a high level of confidence that the whole pandemic was caused by the carelessly implemented laboratory treatment of the virus samples in the Wuhan Institute of Virology, the public perception will change entirely from one day to the next. After millions of Covid-related fatalities, the moral panic will be directed against the Chinese communist regime. Hence, the stake is huge for Beijing. This scenario will destroy the undoubted prestige that China has enjoyed throughout the world for its economic and scientific successes over the past 20-30 years.

The dilemma of how to prevent the emergence of moral panic was not alien to the regime of Donald Trump either. As a President nominated by the Republican Party, he called the COVID-19 danger a Democratic Party “hoax”. Right-wing republicans tended to resist mask-wearing requirements, as a visible sign of a “no-problem” situation. But his attempts failed because by the November 2020 elections, many voters directly blamed Trump for the disproportionate number of COVID-19 deaths, while there was no certainty when the vaccines would arrive. The re-election debacle of President Trump was highly influential on the strategy of the Hungarian prime minister, Viktor Orbán, who faced new elections in April 2022. As a sincere believer in illiberal right-wing governance, he was able to control entirely the media and finance vastly expensive government propaganda campaigns. As different

<sup>1</sup> It was probably on purpose that the Putin regime in Russia introduced the Russian anti-Covid vaccine in 2021 under the product name, *Sputnik* once again.

public opinion surveys showed, he was successful in convincing the majority of the Hungarian public opinion that he was handling COVID-19 successfully. To achieve this, he did not allow the television cameras working in the Covid-hospitals or in nursing homes – the real hotspots of tragedies. Only a narrow circle of clinicians was allowed to go before the cameras, and his Emergency Staff (led by a police general) exercised harsh censorship of morbidity and mortality data. In this way, even the objective part of social media was prevented from disseminating reliable information.

## 5. Globalization: Moral panic of the illiberal left and the illiberal right

We expect the COVID-19 panic to subside or even disappear in a year or so, as efficient vaccines engineered in some countries become available for the rest of the world. But the *global world panic* is intensifying. In the longer term, we anticipate that the most enduring and serious process is the destabilization of the global world system and the resulting attempts to offer ethno-nationalist, nation-state solutions on the one hand, and local, civil society solutions on the other.

At the beginning of the *health crisis* in the Spring of 2020, the first data showed that the world was drifting into a very deep and prolonged recession. As a direct and knowable consequence of lockdowns, stay-at-home orders, and closure of international borders, the world production (particularly in the service sector) literally shut down, causing an *economic collapse* without modern precedent. In March, the American S&P 500 stock market index fell 12.5 %, in its worst month since October 2008. Stock markets in other major countries fell by an average of 30%.<sup>1</sup> The US unemployment rate jumped from 4 % to 15 % by April. In those days, Kenneth S. Rogoff, a Harvard economist and co-author of a history of financial crises, was on record saying, “This is already shaping up as the deepest dive on record for the global economy for over 100 years.”<sup>2</sup> But in May, businesses reopened, and the US economy started to grow again. The same happened in China: in the first quarter of 2020, its GDP fell by 6.8 %, but in the second and third quarters the growth rates were 3.2 and 4.9, respectively. All in all, the growth rate of world output was a negative figure in 2020 (-3.6%), a figure much worse than any number since 1960, but in 2021 the rate bounced back to 5.5 %.

But the threat from *climate change* intensified in 2021, as the summer months brought extreme droughts and wildfires in the Balkan countries, in Siberia and in many parts of the United States. Yes, the authors of this paper acknowledge global climate change, but to what extent is human activity responsible for it? What can we do about it, and at what cost can it be prevented or curbed? These are questions to which we can easily give “alarmist” answers. Is it possible to talk about *trade-offs* (i.e., choices) in these questions, or is Greta Thunberg right in her view that there is only one way to save the world from environmental catastro-

1 One of the top US experts on the subject, Robert Shiller, who predicted the 2008 stock market crash and the subsequent housing market collapse, was predicting once again a recession. *Fortune*, 18 March 2020.

2 „Why the Global Recession Could Last a Long Time”, *The New York Times*, April 1, 2020.

phes and that to do so, we need to panic public opinion?<sup>1</sup> It seems to be an almost truism that the economic slowdown was caused by the coronavirus, the lockdown of the economy, or (in illiberal leftist terms) the coronavirus epidemic was caused by global capitalism, and that the environmental destruction of the global market economy will lead to the demolition of global capitalism.

But we do not see one-way causal links among the three issues. We find it simplistic to assume that the coronavirus was causing the economic downturn. After 10 years of economic prosperity following the 2008 international financial crisis, a recession was to be expected anyway. Both the real estate markets and the stock markets were overpriced, and therefore, a temporary stock market crash was to be expected.

## 6. Conclusion and postscript

Since the beginning of the 19<sup>th</sup> century, it has been known that the capitalist market economy develops in cycles. Already in the early 19th century, many people had shown that there were cycles of 7-11 years, and in his major work, *The Capital*, Marx (1867) attached great importance to what he considered to be periodic fluctuations. A new direction in thinking was given by the Soviet economist Nikolai Kondratyev (1892-1938), who showed that the capitalist economy fluctuates not only in 8-10-year cycles but also in larger cycles of 50-60 years. New technologies have always had a major impact on productivity, like steam engines, railways and electricity. Kondratieff's followers have since described a long 4th and 5th cycle, such as the petrochemical revolution that burst out around 1950 and the information technology revolution that began in the 1990s. Since the 2008/2009 recession, there are new and different candidates: biotechnology, and information technology (possibly robotization).

We do not want to take a position on these complex issues across sectors and say which of these options will materialize, but we have a strong opinion on which is the better analogy: the recent recession of 2008-2009 or the Great Depression of 1929-33. We think it is the former. Indeed, the fact that the immediate precursor to the unfolding recession was not some kind of overproduction crisis, financial imbalance, housing collapse, or a stock market bubble, but an unexpected biological event (the emergence of a new virus) confirms the textbook truth of many decades: cyclical fluctuations in free-market economies are natural, normal but unpredictable events. Large fluctuations are caused not by inherent contradictions of the market economy but by external shocks of various kinds.

But there is little question that the coronavirus has not gone amiss for politicians who are attracted to authoritarian leadership: “we need leaders who know what is in the public interest and can and will act decisively to achieve it”. If the fault lies in multilateral solutions, sovereign nation-states must solve their problems bilaterally. This was reflected back in the “*America First*” slogan. President Trump has withdrawn from the multilateral climate

<sup>1</sup> “I want you to panic”, said the then 16-year-old activist at the World Economic Forum in Davos. *The Guardian*, 25 January 2019.

agreement, denounced the multilateral deal with Iran and started to build a wall on the US southern border to deal with the immigration crisis.

The *America First* slogan has been followed by other countries. For example, the slogan “Hungary First for Us” was used in 2018, and the concept of Brexit in the UK was born in this spirit, too. And this included the decision of the German Constitutional Court on 5 May 2020, which ruled unconstitutional the European Central Bank’s financial rescue operations in 2015, which ultimately succeeded in saving Greece from collapse and preserving the European single currency, the euro. This ruling could well be a very important nail in the coffin of the euro. “European institutions cannot be above sovereign national institutions” was the message of the German constitutional judges. Recently, the Polish Parliament and the country’s constitutional court came to a similar conclusion.

Globalization was born with, and in many ways preceded, modern capitalism. Can we not see the Roman Empire as the most significant institution of globalization at that time? Whatever answer we give to this question, there is no doubt that a new era of globalization has followed World War II. One of the reasons for this was the lessons learned from the Great Depression of 1929-33. The United Nations, UNESCO, the WHO, the IMF, the World Bank, the world trade negotiating forum known as GATT, and a host of other organizations were created to curb nation-state chauvinism. Within Europe, which had been most affected by the two world wars, progress was also made in building pan-European institutions above sovereign nation-states. Winston Churchill had already advocated the idea of a United States of Europe in a speech at the University of Zurich on 19 September 1946. But the process of integration was slow. One reason for this, of course, was the rivalry between the West and the Soviet Union, NATO and the Warsaw Pact. The first - unexpected - globalization turning point was the Helsinki agreement of 1975. This was accepted by both the Soviet Union and its East European allies - at least on paper.

At the same time, the globalization of the economy was taking place worldwide. Capital was increasingly freeing itself from the constraints of nation-states and following the doctrines of Adam Smith and David Ricardo. Companies were moving production to wherever goods could be produced most efficiently and cheaply. Technological change even made it possible to fragment the production process. The various components of any product can be produced anywhere in the world, and the finished product can then be sold somewhere as a “German”, “French”, or “American” product. The profits from this, of course, go to multinationals, which choose the country of production where they pay the least possible taxes. Moreover, the globalization of capital has not yet been followed by completely free labor movement. Nation-states are careful to choose whom they allow across geographical borders. Only those who apply for jobs that “our people back home” are not willing or able to do: farm laborers, careers for the elderly, people with special technical and IT skills, and, of course, professional athletes who make big money in the professional leagues. They often even get citizenship.

Thus, multinationals and globalization in general have become the main enemy of both the illiberal left and the illiberal right. In the eyes of the illiberal left, the multinationals are responsible for the ills of impoverished countries (they are the main branches of the

“*development of underdevelopment*” theory), whose actions lead to poor countries becoming poorer and the rich richer.<sup>1</sup> For the illiberal right, the chief scourge of globalization is that it undermines national sovereignty; multiculturalism is a threat to national consciousness and national culture. Both sides of the political spectrum have blamed globalization for the 2008 crisis. In our view, this is exactly what is happening with the coronavirus epidemic. Many on both the illiberal left and the illiberal right think that we have reached the end of globalization. The illiberal left expects a rebirth of some kind of collectivist socialism (communism), while the illiberal right hopes for the strengthening of ethnically homogeneous nation-states.

There is no question that globalization is a controversial process. First of all, because, as we have already written, the global freedom of capital has not been complemented by similar freedom of labor. Over the last three or four decades, the free movement of capital globally has undermined the welfare states of the Rooseveltian *New Deal*, the Scandinavian examples, and weakened trade unions. National economies increasingly dependent on international supply chains have become vulnerable. To put it metaphorically: if a major country catches a cold, it can easily become global pneumonia. International culture, be it Hollywood or Bollywood, does indeed produce a lot of commercialism. It is also true that the global market economy has not been complemented by an international institutional system that is both global and democratic. The principles of democracy are often undermined in international organizations, and even in the EU.

Yes, international organizations suffer from a democratic deficit, but the authors of this paper argue that it is international organizations – the EU in the case of Eastern Europe – that are best placed to defend human and democratic rights when they are violated by sovereign national or communist governments. After all, it was the Hague tribunal that brought justice for the Serb atrocities in Bosnia, and it is bad enough that the United States does not recognize this tribunal and excuses US citizens who have committed war crimes around the world.

However, it is hard to deny that the causal links between the triple crisis, the economic and health crises, and globalization are complex. Yes, globalization of the economy played a role in the onset of the 2008 crisis, but it was the World Bank, the IMF, the WTO and the EU that developed workable solutions to resolve it relatively quickly and painlessly. Globalization sharply increased some inequalities (more and more billionaires and more and more wealth in the hands of the top 0.1 % of each country), but the rise of free markets in China and India, the two most populous countries in the world, has radically reduced the number of people living in poverty and significantly increased life expectancy in both countries (Mihályi – Szelenyi, 2017). What has been achieved in terms of the free movement of people is also seen as a huge asset. Before the epidemic, Chinese tourists to Europe and America were arriving in their millions, and there was also a huge reverse movement. When China closed its international border in early 2020, nobody expected that it would remain closed for two years.

In our view, only a global, multilateral response to these challenges is possible. The illiberal right looks to ethnically homogeneous and sovereign nation-states, the illiberal left to local,

1 Indeed, there were many examples of this in Latin America in the 1960s.

civil society organizations (or communist parties) for the solution. There are some issues where nation-states or local/civil society organizations can be effective, but to say that they will solve the big problems is simply wrong. Our conclusion is this: faced with the great challenges of the 21<sup>st</sup> century, the most urgent task for social scientists is to carefully analyze moral panics. There is enough trouble in the world. Panic is understandable, but not unjustified. Rational reflection is a better adviser in all cases.

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The first draft of this paper was submitted in September 2021, five months before Russia invaded Ukraine and, by doing so created a devilishly risky situation for the major actors of international politics: NATO, the European Union, as well as for China. The fear of a nuclear clash is on everybody's mind. What has evolved so far, however, is *not* a moral panic, as we use the term in this paper. Thus, we do not need to rewrite our paper. From a Western perspective, the threat from Putin's Russia is *not* exaggerated, and (so far, we emphasize again) the liberal democracies *do not blame themselves* for the threatening disaster. Although the present authors are not happy with the reactions of the Russian public opinion, we do not see the signs of moral panic in that country, either. Ironically, this can be a source of further risks and dangers.

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## 12. The war of the Russian Empire against Ukraine: The most dangerous phase of the post-communist transition

### *The facts of the post-communist transition<sup>1</sup>*

In 1987, 26 socialist countries on four continents held 31% of the world's land. 34% of the total population lived in these countries. For this to change, both the *de facto* and *de jure* break-up of the Soviet Union and the abandonment of communist ideology were necessary. The Union of Soviet Socialist Republics (commonly known by its Russian acronym: CCCP) was dissolved on 26 December 1991 by agreement of the presidents of the three Slavic founding states – Russia, Ukraine, and Belarus. The 12 other member states declared their independence, and Russia recognised all the successor-states as sovereign. By 1995, only two countries, Cuba and North Korea, were still operating a planned economy and Soviet-style one-party system. Five years after the regime change, this seemed to be all that was left of the socialist world system. Around 2010, after the border changes, 38 countries could be classified as 'transition economies', describing the switch from a centrally planned system to a market economy model.<sup>2</sup> At that time, it seemed clear that Russia and China were also rapidly moving towards marketisation and liberalisation, as predicted by Fukuyama.<sup>3</sup>

Until 2022, the start of the Russian invasion of Ukraine, it seemed that, by historical standards, humanity had survived this dramatic transition on the cheap. Of course, it was well known that there had been major military confrontations in the Balkans and the post-Soviet space after 1989, but until the recent Russian-Ukrainian war, these conflicts seemed to have been limited in time and space, and even in casualties, and the possibility of using weapons of mass destruction had not even been raised. As is well-known, compared to the Cold War period (1947–1991), Russia has significantly reduced its nuclear arsenal, and three new post-Soviet states – Belarus, Kazakhstan and Ukraine – have voluntarily 'returned' their nuclear weapons to Russia.<sup>4</sup>

### *The pretexts and underlying reasons for the war against Ukraine*

Yeltsin's Russia recognised Ukraine's sovereignty in 1991 and confirmed it in December 1994 in the form of an international treaty (Budapest Memorandum). But these were only legal steps. Russia's political assessment was different, although this did not attract much international attention at that time, let alone objections. Putin said as early as 2005 that 'the break-up of

1 Based on a symposium lecture at the Hungarian Academy of Sciences, 23 November 2022. First published in English in *Hungarian Journal of Legal Studies*, Vol. 64. No 4.

2 Mihályi and Szelenyi (2021).

3 Fukuyama (2018; 2022).

4 Szelenyi and Mihályi (2019).

the Soviet Union was the greatest geopolitical disaster of the 20<sup>th</sup> century'. He went on to say: 'For the Russian people, the fact that tens of millions of our fellow citizens and compatriots have been displaced outside Russian territory has become a real drama. The epidemic of collapse has spread to Russia itself<sup>1</sup>. Some years later, these sentences were repeatedly quoted by foreign observers, but it was not clear until 24 February 2022 what the consequences of these statements would be.

Of the many threads of events, those in Ukraine were – in hindsight – the most important. On 21 November 2013, mass protests began in Kiev after President Viktor Yanukovych, a pragmatic and/or pro-Russian politician, unexpectedly announced that he would not sign the Association Agreement offered by the European Union, despite the fact that it had already been approved by an overwhelming majority in the Ukrainian parliament. This was the beginning of the second Orange Revolution. The conflict culminated on 18–20 February 2014, when police used force, killing nearly 100 protesters, with 13 police officers also losing their lives. Yanukovych then fled to Russia, and a caretaker government took control. Putin described Yanukovych's removal and the subsequent free elections as illegal. Moreover, he disputed on principle that Ukraine had the right to choose the European Union and NATO. In other words, Moscow had already questioned Ukraine's sovereignty in 2014, but even then, the news did not shock international public opinion (and thus not the Hungarian public, either).

However, it was at that point that Russian-speaking 'volunteers' wearing unmarked uniforms marched into Crimea and into two predominantly Russian-speaking provinces of Ukraine. Two nominally independent and sovereign 'states', the People's Republics of Luhansk and Donetsk were created by force of arms, and the Russian Federation granted permission to them to join the Russian Federation at the 'request' of the Russian nationalists who *de facto* ruled Crimea. Moscow's official justification was that the Russian 'volunteers' were defending the Russian-speaking minority in Ukraine against the oppression of the Ukrainian majority. From then on, Putin and his immediate associates made several statements questioning the existence of Ukraine or the Ukrainian language. How different the two languages and cultures are is not a straightforward fact. But it is a fact that such differences can be found in many parts of the world (e.g., in the Balkans).

It can be argued that it was wrong for Ukraine to declare Ukrainian the official language of the country in 2019, but there is no convincing and sufficient evidence that the Russian minority has suffered atrocities. It is also well known that many Russian-speaking adults – including President Volodymyr Zelensky – now consider themselves Ukrainian. The justification Putin invoked at the start of the war was nothing more than a transparent lie. In Putin's words, in Ukraine, the special military operation has been designed to protect people who have been abused and subjected to genocide by the Kiev regime for eight years. And to that end, we will seek to demilitarize and denazify Ukraine and bring to justice those who have committed numerous bloody crimes against civilians, including citizens of the Russian Federation.<sup>2</sup>

<sup>1</sup> President Putin made this point in a televised address to the country's citizens, choreographed after the American model, in his annual address on 25 April 2005. See Link1.

<sup>2</sup> Extract from a TV speech to Russian citizens at the outbreak of the war on 23 February 2022. See Hinton (2022).

If Ukraine as a state did not exist and had no reason to exist, then the sovereignty of the other successor states of the Soviet Union is also questionable.<sup>1</sup> And indeed, Putin has made several allusions during the last decade to his own personal commitment to become a successor and heir of Peter the Great's (1672–1725) legacy<sup>2</sup>. Putin seems to be determined to re-colonize and re-integrate the northern and western territories of the former Soviet Union, which were first conquered by Peter the Great.

In our opinion, the most important reason for the Russian-Ukrainian war is that the regime change, the post-communist transition, has not brought Russia the hoped-for result of economic catch-up with the West. After the dissolution of the Council of Mutual Economic Assistance (CMEA) and the Warsaw Pact in 1991, and the subsequent failure to create truly viable successor organisations involving the 15 former allied republics of the Soviet Union, Russia was essentially left on its own on the world stage in foreign policy terms.<sup>3</sup> It is in a worse position than it was immediately after the loss of the Cold War in 1989. From Moscow's perspective, the Chinese catch-up strategy also seemed more successful than what they were doing (Table 1).

Indeed, Russian leaders must have been aware that even the relative successes of the Russian economy (for example, its GDP growth between 1999 and 2013) were largely due to an exogenous factor – the rise in international oil and gas prices.<sup>4</sup> In 1991, many Russians hoped that they would soon belong to Europe, and even Putin was considered a 'zapadnik' (Westerner) until 2000. By 2022, however, largely because of Ukraine, the 'West' in general, and the United States and NATO in particular, were seen as the main enemy. Now the argument is that Russia has to be protected from harmful Western and/or American interference. That is why President Putin and Foreign Minister Lavrov repeatedly try to interpret the Russian-Ukrainian war as a US-Russian war.

Economically and socio-politically, Ukraine has not been successful, either. In fact, in a comparison between the two countries, Ukraine's performance was even worse (Table 2).

In the post-1991 period, Ukraine's GDP growth was even slower, and in the years before the outbreak of the war, Transparency International's corruption perception index was almost as shameful as Russia's. Demographic changes have also presented a worrying picture. While the world population has grown by 40% in the last 30 years, the US by 30% and China by 20%, Russia's population has stagnated, and Ukraine's has declined by 20%.

1 Mihályi and Szelenyi (2022).

2 This was the special occasion of his presidential visit to the Peter the Great exhibition in June 2022. In his speech, Putin tried to compare Peter the Great's war to conquer Sweden with his own military invasion of Ukraine. He implied that Russia's action was justified because Ukraine is not a legitimate sovereign nation but is in fact Russian territory.

3 Although in 1992 Russia was able to get the six successor states of the Soviet Union (Russia, Armenia, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan) to establish a form of military cooperation called the *Collective Security Treaty Organisation* (CSTO), the differences in scale meant that Russia was not significantly stronger than it would have been on its own. In fact, Bismarck's saying – 'the strong alone is the strongest' – is very valid for this situation.

4 The price of oil per barrel rose from \$19 to \$88 during this period, but since then there has been no trend rise, only fluctuations.

On the military front, all the data indicated that Russia is stronger than Ukraine, not only as a nuclear power, but also in terms of conventional weapons. It was, therefore, logical that Putin began Russia's empire-building war by attacking Ukraine. The stronger attacks the (much) weaker: this is the cardinal rule of evolution. Ukraine had 186,000 active soldiers at the start of the war, compared to 900,000 in Russia. As Putin put it in a nostalgic interview in October 2015: 'Fifty years ago, the streets of Leningrad taught me a very important lesson: "if a fight is inevitable, you must strike first".'<sup>1</sup>

The Russians apparently did not expect the Ukrainians to put up fierce resistance, perhaps even thinking that they would not put up any resistance at all, as happened during the invasion of Czechoslovakia in 1968, to avoid senseless losses.<sup>2</sup> Thus the first Russian attack on Kyiv ended in an embarrassing defeat. After that, Western arms supply, massive financial aid to the Ukrainian Government, and a succession of economic sanctions against Russia were launched. For Russia, being in a dead-end street, the use of nuclear weapons may seem to be a promising solution at any time. A situation similar to that of the Cuban Missile Crisis (1961), can arise once again, when the two superpowers came very close to launching nuclear missiles, with the possibility of a third world war. It is difficult to interpret differently the words of former President Dmitry Medvedev, who said in an interview:

*"Russia has the right to defend itself with nuclear weapons if it is forced to, and this is certainly not a bluff. [...] Imagine that Russia is forced to use the most formidable weapon against the Ukrainian regime, which has committed aggression on such a large scale that it threatens the very existence of our state."*<sup>3</sup>

This was said by Medvedev in September 2022, who is currently Vice-President of the Security Council, chaired by Putin.

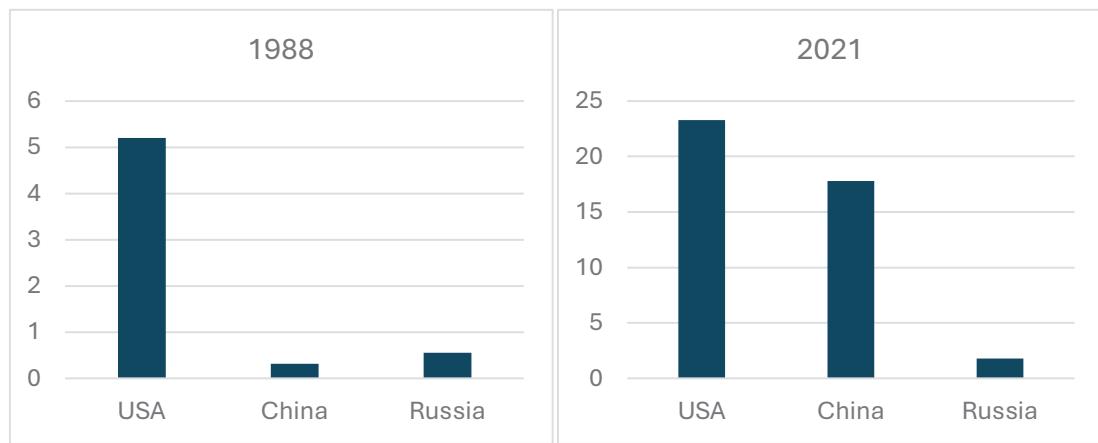
There is another historical analogy, worth quoting. There is one aspect of the current war that makes the conflict similar to the Spanish Civil War period (1936–39). This is the proxy nature of the war. It is neither easy to translate nor to explain the *proxy war framework* that Moscow is now presenting with respect to the situation in Ukraine (Hughes, 2022). We all live through an armed conflict, in which global or regional powers do not participate directly, but only with the support (diplomatically, financially and/or with arms) of the local belligerents. In the case of the Spanish Civil War, Nazi Germany, Italy, Portugal, etc., supported the Francoists. The International Brigades, with soldiers from over fifty countries, fought on the side of the Republicans, with financial support and arms supplies from the Soviet Union. The Russo-Ukrainian war is taking a different form partly because the Western powers supporting Ukraine with arms and money, the United States, NATO and the EU, learning from the example of the Spanish civil war, have so far only sent Ukraine arms, not soldiers. In other words, the analogy is not entirely unfounded, but it is not entirely correct. But it is no coincidence that Russian diplomacy tries to use this expression as often as possible.

1 Buckley (2015).

2 Before the Warsaw Pact troops attacked, all Czechoslovak military units were given clear orders not to leave their barracks. This could, in theory, have happened in Ukraine.

3 Link2.

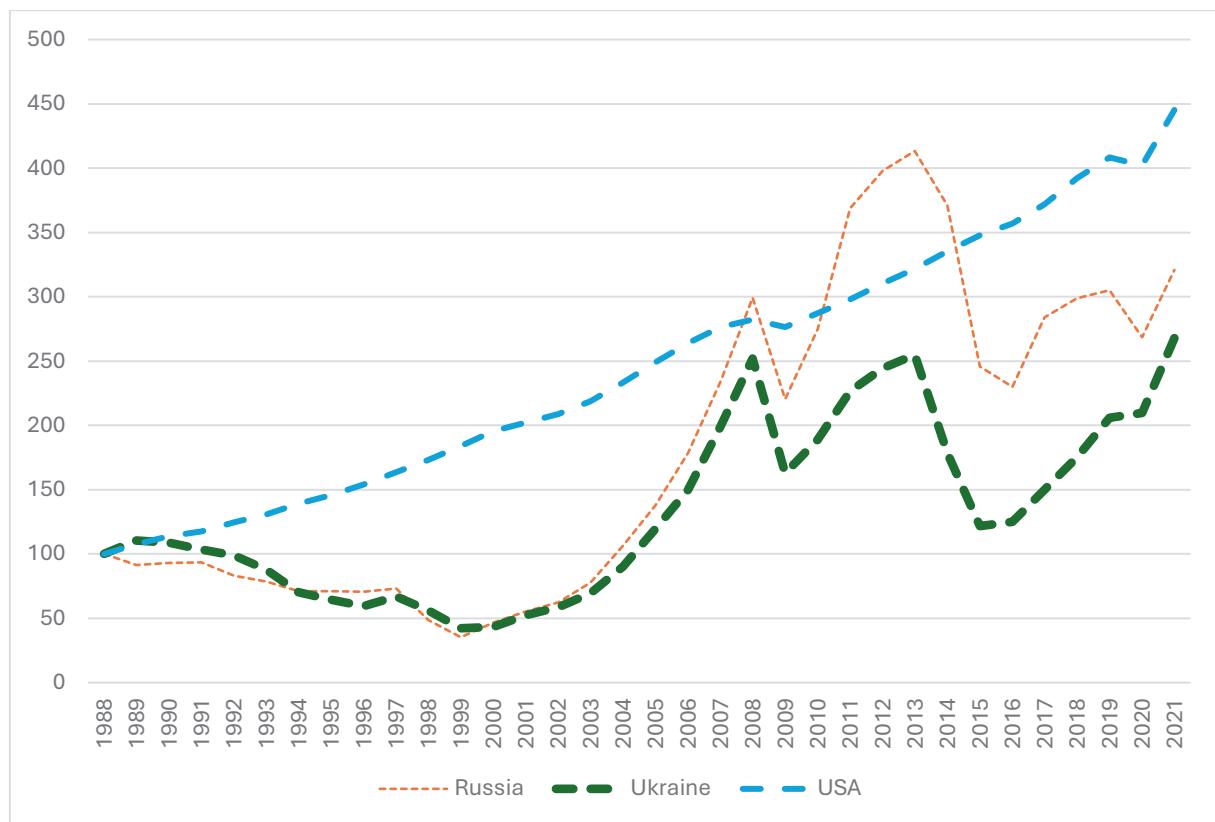
Figure 1. Largest economies by nominal GDP (Trillion US dollars)



Source: Authors' calculation based on World Bank data.

Figure 2. GDP trends in the United States, Russia and Ukraine, 1988–2021

Index, 1988 = 100



Source: Authors' calculation based on World Bank data.

The message that Russia has been defeated militarily by Ukraine (a much smaller country) is quite different from saying that Russia was forced to make peace only by the united 'West', i.e., the US, NATO and the EU. There is also logic in the view that a proxy war can, in principle, be abandoned by either side, as the US did during the Vietnam War (1965–1973). At a certain point, the United States withdrew its support from the South Vietnamese regime, and this resulted in victory for the Soviet-backed communist regime in North Vietnam. There is one problem with this analogy: the defence of Ukraine is a thousand times more important to NATO, the US, and the EU than the Vietnam War was at the time. We must therefore see that this proxy war problem is part of the cornered state of affairs whose risks have been mentioned above.

There is also a serious risk, the reality of which can only be assessed if we know much more about the details of the Russia-China relationship. We are thinking of the unpredictably dangerous world political situation that would arise if, during the Russo-Ukrainian war, China was to attempt to invade Taiwan and tie up US forces in the Pacific, thereby indirectly strengthening President Putin's position in the theatres of war in Ukraine.

### *What Putin has set out to achieve is impossible*

Before its collapse, the Soviet Union had a territory of 22.4 million km<sup>2</sup>; today, the Russian Federation controls 17.1 million km<sup>2</sup>. The difference (5.3 million km<sup>2</sup>) is greater than the total territory of the European Union (4.3 million km<sup>2</sup>). Conquering even close to this area in the post-communist transition era, or at any time in the foreseeable future, is unthinkable. For the Soviet Union had a false – and never accepted by many, but attractive to many – universal atheistic ideology, namely the ideal of communism, the ideal of liberating all of humanity. It held the 15 Member States together for 70 years. It also fitted in well with the model of a multi-ethnic federally organised state and the fact that some of the leaders of the Soviet Union were not born in Russia and/or were not of Russian nationality on both their father's and mother's side and did not follow the Orthodox faith (Stalin, Trotsky, Dzerzhinsky, Beria, Khrushchev, Gorbachev, etc.).

In a symbolic sense, this was expressed by the fact that the anthem of the Soviet Union was the *International Communist Anthem* until 1944. Only then was the State Anthem born, reflecting a more Slavophile sentiment, which replaced the reference to the interests of the international proletariat with the defence of Russian interests. Already, the first two lines reflected this: 'An unbreakable union of free republics/The Great Rus' has sealed forever.' For Putin, however, a return to communist ideology is hardly conceivable. Nor can the last three lines of the Soviet Anthem be taken as a common goal: 'The Party of Lenin – the strength of the people/Leads us to the triumph of Communism'<sup>1</sup>

It is now forgotten, but it is a fact that in August 1991, after the failed coup against Gorbachev, it was Putin's predecessor, Yeltsin, who, with great abruptness, as President of the Russian Federation, banned the USSR Communist Party. This cannot be undone, and not only be-

<sup>1</sup> Link3.

cause the USSR Communist Party has a successor party, the Communist Party of the Russian Federation, which has defined itself for two decades as the opposition to the Putin regime in the Russian Parliament. Therefore, Putin can hardly do other than refer to the glorious Russian history, seeing himself as Peter the Great. His own mission is to forge a kind of New Russia<sup>1</sup> or Greater Russia on a territory even larger and more powerful than that which Peter the Great had acquired for himself and his country (12 million km<sup>2</sup>). To do this, he can also draw on the Orthodox religion, and indeed, he has a lot of support in Russia – his popularity was around 80% when Crimea was conquered. But the neighbours of Russia today, which he would like to annex, and from which the missing 5.3 million km<sup>2</sup> mentioned above could be mathematically added up, i.e.

- Kazakhstan (2.7 million km<sup>2</sup>)
- Mongolia (1.5 million km<sup>2</sup>)
- Afghanistan (0.7 million km<sup>2</sup>) and
- Ukraine (0.6 million km<sup>2</sup>)

and the countries that are relatively easy to occupy – Belarus, Moldova, or Georgia – would not strengthen Russia significantly even if they were successful. Nor are other potential partners keen to see Putin's Russian empire strengthened. Turkey itself has great power ambitions, and the Central Asian countries that are still in the running are more aligned with Turkey than with Moscow. China also does not want a successful and powerful Russia on the other side of the 4,300-kilometre common border.

In Putin's view, the states along Russia's current border can only have limited sovereignty.

'A new era is coming, a new stage in world history. Only truly sovereign states are capable of showing others a model of development in which man becomes not a means but the ultimate end.'<sup>2</sup> Neighbouring states, even those that were never states of the Soviet Union, must be neutral at a minimum (Sweden and Finland, for example). But the Russian leadership can legitimize its current power and its future ambitions to change the *status quo* with nothing other than an appeal to Russian national interests. In other words, the fundamental self-contradiction of the current concept is that the *Slavophile, ethno-nationalist, Pravoslav ideology and Putin's cult of personality are unacceptable to any other country*.

At the outbreak of the war, Putin hoped that he could at least achieve that

- (i) NATO would not take in new members and
- (ii) there would be no NATO troops in the countries that joined NATO after 1989.

These two objectives were taken off the agenda during the first few weeks of the war. Not because Putin changed his mind, but because it became clear that he did not have the power to force these objectives.

1 The name New Russia (Novorossiya) has already been thrown into the public consciousness by Putin in 2014-2015. This internationally unrecognised puppet state in eastern Ukraine, was formed as a union of the Donetsk People's Republic and the Luhansk People's Republic. This construct no longer exists on paper, after the two republics and two regions, Kherson and Zaporizhzhia, were merged into the Russian Federation in the 8th month of the war.

2 Extract from a speech in 2022. See link4.

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## Links

Link1: 'Putin: Soviet collapse a "genuine tragedy"', *NBC News* (25 April 2005) <<https://www.nbcnews.com/id/wbna7632057>>

Link2: 'Russia's nuclear threat certainly not a bluff, warns Putin's ally. Medvedev is one of Putin's closest associates and is widely seen as expressing the Russian president's views', *Deccan Herald* (27 September 2022) <<https://www.deccanherald.com/international/world-news-politics/russias-nuclear-threat-certainly-not-a-bluff-warns-putins-ally-1148661.html>> .

Link3: 'State Anthem of the Soviet Union', *Wikipedia* <[https://en.wikipedia.org/wiki/State\\_Anthem\\_of\\_the\\_Soviet\\_Union](https://en.wikipedia.org/wiki/State_Anthem_of_the_Soviet_Union)>.

Link4: 'Putin: "Global Reorganisation Of Sovereign States Is Occurring Into A Multipolar World"', *Russia Briefing* (21 July 2022) <<https://www.russia-briefing.com/news/putin-global-reorganisation-of-sovereign-states-is-occurring-into-a-multipolar-world.html>>