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Misuse of institutions: Lessons from Transition

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Working Paper No. 2010/75

Misuse of Institutions

Lessons from Transition

Leonid Polishchuk*

June 2010

Abstract

The paper explores a phenomenon often observed in transition economies, when newly established institutions are misused, i.e., applied or resorted to for reasons which have little in common with their intended or anticipated purpose. In such incidences institutions become sources of private gains and lose their value-creation role and capacity. We offer a typology of institutional misuse (illustrated by examples from Russian transition), discuss its consequences, and explore reasons why governments and societies fail to serve as institutions' guardians. Implications misused institutions for economic and political reforms are analysed.

Keywords: institutions, transition, capture, club goods

JEL classification: D02, D72, D78

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> Our institutions and all of that are like birch trees that we've thrust in the ground on the St. Trinity Day to make it look like a forest that grew naturally in Europe. …
>
> Birch trees … which are planted need careful treatment. … Only those nations have a future that posses a sense of what is important and significant in their institutions, and value those.
>
> Leo Tolstoy, *Anna Karenina*

1 Introduction

The essence and purpose of reforms in transition and developing countries have been to supply institutions that support markets, protect property and contracts, and ensure accountable governance in the private and public sectors and efficient delivery of social services. Such emphasis on institutions is consistent with the massive literature providing evidence of the key role of institutions in economic development and welfare (see e.g., Acemoglu, Johnson and Robinson 2002; Easterly and Levine 2003; Kaufman, Kraay and Mastruzzi 2005).

An equally compelling body of evidence, however, attests to the widespread failure of newly introduced institutions to deliver the expected results. Many economies and societies demonstrate 'institutional invariance' (Acemoglu and Robinson 2008), when reforms do not affect the pre-existing social, economic and political order, and newly introduced institutions have little, if any, impact on the status quo ante. Such failures blur the link between institutions and development and give rise to the contrarian views that put the causality in reverse: good institutions are *outcomes* of development, not vice versa (Glaeser et al. 2004).

Non-performing institutions are attributed to cultural rejection and 'bad fit' (Cooter 1997; Rodrik 2000, Polterovich 2001; Berkowitz, Pistor and Richard 2003); to inconsistency of a given institution with the rest of the institutional setup, including a mismatch between newly introduced fast-moving and pre-existing slow-moving institutions (Roland 2004); to incompleteness of reform whereby due to institutional complementarities (Aoki 2001) absence of essential institutions adversely affects those already in place (Hellman 1998); and to multiplicity of equilibria and "institutional traps' (Roland 2000; Polterovich 2007).

This paper points out to a yet another commonly observable cause, consonant with the above explanations: institutions could be *misused,* i.e., applied or resorted to for reasons which have little in common with their intended or anticipated purpose. An institution is misused by exploiting the opportunities that it creates in unforeseen ways unrelated to its primary *raison d'être*. Such institution, when applied destructively (Polterovich 2001), becomes a source of private gains (rent) for opportunistic agents at the expense of the rest of society; it loses its initial value-creation role and capacity and is turned into a vehicle for re-distribution, often causing aggregate losses of efficiency and welfare. Acemoglu, Robinson and Johnson (2002) make distinction between 'institutions of private property' and 'extractive institutions': the former serve as public goods/production inputs advancing economic development, whereas the latter are rent-

extraction tools which impede development. In terms of this dichotomy, misuse disables a private property-type institution and transforms it into an extractive one.

The paper is organized as follows. In the next section common patterns of institutional misuse are analysed and illustrated by examples drawn primarily from the Russian experience (although also observed elsewhere in transition and developing countries). Causes of institutions' vulnerability to misuse are discussed next, with particular attention to failures of society and state to properly protect institutions. The analysis highlights the role of social capital as a safeguard against misuse of institutions, thus supporting the view that social norms, culture and capacity for collective action are essential for economic development and welfare (Keefer and Knack 2005; Tabellini 2008a). Without social capital, institutions are left unprotected at the grassroots (Section 3), while unaccountable government is restricted in its enforcement tools and caters to organized interests, and thus also fails to serve as an institutional guardian (Sections 4, 5). The concluding Section 6 discusses implications of the pitfall of misused institutions for economic transition.

2 How institutions can be misused?

In a variety of forms in which institutions are misused several broad patterns are emerging. First, institutions can be *manipulated*, second, used as a *cover* to conceal questionable or illicit activities, third, *captured* and subverted by narrow interests.

2.1 Manipulation by institutions

Institutions can be manipulated due to either laxity of controls of compliance with institutions' rules, or by imprecision of such rules that allows behaviour conforming to the letter of institutions but frustrating their spirit and purpose.

In the former case an institution loses its ability to reduce uncertainty by sending signals of otherwise unobservable traits and behaviour. The value of such signals depends on the strength of the institution's internal and external control mechanisms. When enforcement mechanisms malfunction, public trust in an institution can be exploited to mislead the society about the true type of an agent and his/her behaviour. As the number of violators grows bigger, confidence in the institution progressively declines and the institution is losing its reputation—an asset critically important for the ability to serve as a credible signalling device.

A telltale illustration of this process can be found in the *non-profit sector*. A major comparative advantage of non-profits over for-profit firms is that the former provide additional assurance to customers of otherwise uncertain quality of goods and services (credence goods). Since operational surplus (if any) cannot be distributed to non-existent private owners of a non-profit firm, incentives to cut costs by lowering unobservable quality are weaker than in the for-profit case (Hansmann 1980). However, if the non-distribution condition is not properly enforced, unscrupulous operators can take advantage of the statute and reputation of the non-profit sector without following the rules on which such reputation rests. In an ensuing 'pooling equilibrium', credibility of the non-profit sector deteriorates and rent-seekers crowd out bona fide non-profits: the latter are forced to reduce the scale of their activities and/or quality of goods and

services, since the scepticism of customers and donors does not generate sufficient revenues to allow cost recovery at the previously available level (Polishchuk 2008a).

Similar processes recently unfolded in the Russian *post-secondary education*. Uncontrollable proliferation of private universities and colleges and commercialization of public institutions of higher education were driven to a large extent by profit-seeking motive. Competition between schools dramatically *reduced* academic standards and the quality of education, as universities and colleges were luring in prospective students by promising degrees that would require minimal time and effort. The diminishing premium that such degrees earned in the labour market sustained the expansion of the post-secondary education sector as long as the willingness to pay for an increasingly worthless diploma still covered reduced costs of operating a university (Polishchuk and Livny 2005). The ability of such educational system to enhance human capital was severely compromised.

Another (but closely related) pattern of manipulation by institutions exploits imperfections of the laws establishing and upholding formal institutions. Laws are 'incomplete contracts' and often leave open to interpretation grey areas, which are filled by courts and regulators (Pistor and Xu 2003). When such interpretation is not sufficiently consistent and robust, incompleteness of laws makes them vulnerable to misuse, whereby the letter of the law is observed but its intent violated. This can be illustrated by the Russian *bankruptcy law* (Polterovich 2001; Polishchuk 2008b). The institution of bankruptcy is expected to protect creditors and improve efficiency of corporate governance, but can also be misused by 'corporate raiders' for takeovers of sound businesses and asset stripping. In the latter case application of the bankruptcy law is based on technicalities while substantive reasons for bankruptcy proceedings are absent. Russia witnessed a wave of 'contracted bankruptcies' targeting viable companies attractive for corporate raiders, whereas loss-making and debt-ridden companies, intended targets of the institution of bankruptcy, were rarely touched. Lack of transparency in the corporate sector and weakness of the court system were factors contributing to such practices.

2.2 Institutions as cover

Institution could be misused to hide activities that cannot be conducted in the open, and to represent them as legitimate and sanctioned by institutions-'covers'. This pattern can be illustrated by the misuse of *corporate social responsibility*. Often, modern corporations voluntarily comply with enhanced environmental, social, ethical, etc. performance standards in excess of what is required by laws and regulations, and support various charitable causes. Such behaviour is motivated by seeking competitive advantages in selling to socially conscious customers, or is in response to grassroots societal pressure which subjects companies to 'civic regulation'. At the same time, corporate social responsibility can be misused by government officials to coerce businesses into financing off-budget projects and programmes, or to accommodate agreements between firms and bureaucrats where corporate support to government's pet projects is traded for preferential access to markets, resources and procurement contracts, or to tolerance to violations by companies of existing laws and regulations. Although such practices could be detrimental to economic efficiency and social welfare (see, for example, Shleifer and Vishny 1994), they are legitimized under the guise of

corporate social responsibility and as such have become commonplace in modern Russia (Polishchuk 2009).

Another example of the same pattern is the misuse of the institution of *intermediaries*. Intermediaries are indispensable in modern market economies: they support exchanges by cutting transaction costs. However, intermediaries can also be instrumental in reducing transaction costs of illicit activities—for example, by handling a criminal part of a transaction and disappearing afterwards ('fly-by-night' operations). An important role of intermediaries is to assist in meeting legal and regulatory requirements set by the government, where intermediaries take advantage of specialization and economy of scale in processing a large number of similar cases on behalf of their clients. Here, too, there is a dark side: intermediaries can be instrumental in abetting corruption by dramatically reducing its risks and transaction costs. Symbiotic relations between intermediaries and corrupt officials provide the latter virtual indemnity from prosecution, since those who have material evidence of bribery have no incentive to blow a whistle (Lambsdorff 2002). This can aggravate damage caused by corruption (Polishchuk, Shchetinin and Shestoperov 2008).

2.3 Institutional capture

Capture and subversion are perhaps the best-known patterns of misused institutions. Capture puts an institution under control of a narrow group that operates the institution or is affected by its performance. Thus, observed practices of *economic regulation* intended to serve public interest often better conform to the 'public choice' view (Stigler 1971), where the institution of regulation is controlled by interest groups in the private sector or government bureaucracy. The public choice view explains broad international variations in the regulation of entry: taller barriers are not shown to yield higher health and public safety standards, more competition and better protection of consumers' and workers' rights, etc.; rather, they are associated with corruption and vast shadow economy (Djankov et al. 2002). The informal sector does not provide an enabling environment for small and medium businesses, and excessive entry barriers, instead of serving public interests, retard economic growth and entail massive efficiency losses (De Soto 2000). The beneficiaries of such regime, apart from corrupt bureaucracy, are the economic elite that are able to clear the elevated entry barriers and earn higher returns to their assets due to reduced competition in the formal sector (more on this in Section 5).

An institutional alternative to regulation—the *courts system*— can also be prone to misuse. The intended purposes of courts are to ensure fair and predictable resolution of disputes over torts, property and contracts. By means of threats, bribes and/or political influence courts can be misused for expropriation of income and property through legal sanction obtained from a subverted justice system, or by denying justice to victims of expropriation. Such outcome is particularly likely against a backdrop of profound economic and political inequality when wealth and power create advantages in influencing courts (Glaeser, Scheinkman and Shleifer 2003).

A yet another example of misuse by subversion is the *capture of subnational governance* in a federal system. Well-known advantages of decentralized system of government, such as greater flexibility of fiscal policies and stronger performance incentives in the public sector, do not materialize automatically, which can be seen from numerous instances of decentralization failures, and one reason is the capture of

devolved government prerogatives at the regional and local levels. Such risks are aggravated by greater likelihood of emergence in a smaller jurisdiction of a dominant interest group (Bardhan and Mookherjee 2000; Blanchard and Shleifer 2001). Widespread capture of regional governments that occurred in Russia in 1990s denied the country economic benefits of federalism (Polishchuk 2004) and was a contributing factor of the prolonged recession and political instability that continued through most of the decade.

3 Why is misuse unopposed? The role of social capital

Institutions that are supplied exogenously in a process of economic reform differ from those that have evolved endogenously as self-enforcing equilibria (North 1990; Aoki 2001)—the anticipated use of the former might not be incentive-compatible, in which case such institutions could be misused. If the proper use of externally established institutions is not an equilibrium outcome, third-party enforcement is required to ensure proper performance (Roland 2004). The scale and scope of institutional misuse observed in Russia and some other transition countries show that such enforcement is often inadequate.

Perpetrators of misuse gain at the expense of bona fide users who are denied the benefits of the misused institutions. Why are institutions not defended by those who value their legitimate use and thus suffer from misuse? One can offer several plausible explanations all of which invoke social attitudes and values and find a degree of support in the Russian evidence.

First, society could be indifferent to misuse if affected institutions are not viewed as valuable and worth protecting, e.g., when there is no prior experience of utilizing such institutions that would have demonstrated their value. A case in point are the social attitudes to political rights and freedoms in countries with limited history of non-despotic form of government.[1] Unawareness of importance of such rights for economic wellbeing makes democratic political institutions shaky and open to misuse.

Pre-existing social values and business practices could be a factor preventing or condoning misuse of newly enacted laws. Effectiveness of such laws depends on whether they are meaningful in the local context, consistent with prevailing norms, and meet demand of the society and private sector (Cooter 1997; Berkowitz, Pistor and Richard 2003). Such conditions create appreciation of the new laws, incentives to use them properly, and willingness of private individuals to assist the state in upholding and enforcing the law. Otherwise, laws '… will either not be applied or applied in a way that may be inconsistent with the intention of the rule in the context of which it originated' (Berkowitz, Pistor and Richard 2003: 174). If a legal system in general is discredited by a history of manipulation in the hands of powerful (Pistor 1999) or wealthy (Glaser and Shleifer 2003), continued misuse is tolerated as 'business as usual'.

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1 Recent opinion polls in Russia reveal high appreciation of social and economic rights, which are valued by a majority of respondents, whereas the percentage of those who value political rights and freedoms is several times smaller (VTSIOM Press Release 1395, 2009).

Social norms and values can themselves be considered as institutions, albeit more inertial and slower-moving than those purposefully established in the process of institutional reform. From this perspective a mismatch between modern institutions and traditional culture (norms, values and beliefs), which allows the former to be misused, illustrates possible inconsistency between fast-moving and slow-moving institutions (Roland 2004).

Public appreciation of institutions and hence willingness or lack thereof to uphold them at the grassroots, could also be strongly affected by events of recent history. If a new institution fails to deliver from the outset and initial positive expectations are frustrated—perhaps due to misuse at an early stage, when the institution is still fragile—public support to such institution will be withdrawn thereafter, and further misuse will continue unimpeded. This can be illustrated by the Russian federal system, which had no solid foundations in the national political culture and no historical precedents of any depth and significance (Polishchuk 1999), and was in part a reaction to the egregious failures of the Soviet hyper-centralization, in part a political compromise of the early 1990s crafted to co-opt restive regional elites in a constitutional regime promoted by a weak central government. Absent of social and cultural anchors, federalism-Russian style was prone to excesses of the early-to-mid 1990s with a nearly disabled federal centre, and succumbed to the subsequent over-centralization when political winds changed direction.

Second, even if an institution is perceived as valuable, its protection against misuse poses a collective action problem typical for grassroots provision of public goods.[2] Unresolved collective action problem is a common cause of persistence of inefficient or dysfunctional institutions (Olson 1982; Roland 2004), including those which are misused.

Capacity for collective action is based on *social capital*—a set of norms, values and networks that facilitate joint efforts for a common cause (Keefer and Knack 2005). Social capital is a potent factor of economic development and welfare (op. cit.), similar in its significance to conventional institutions such as property rights, markets, private and public sector governance, etc. Moreover, social capital contributes to economic outcomes largely *through* institutions—performance of the latter is shown to depend on trust, mutual respect, cooperation and other values and patterns of behaviour comprising social capital (Tabellini 2008a).

Relationship between (conventional) institutions and social capital continues to be a matter of debate. Data show a degree of substitution between these two factors; in particular, social capital can partially make up for weak or missing institutions (Kranton 1996). Such substitution, however, appears to be unidirectional: when social capital is in short supply, rampant misuse could debase institutions that are neither trusted nor respected. Thus, sustainable democracy and rule of law are rested on *civic culture*, a special kind of social capital that includes a broadly-shared vision of unalienable political and human rights and readiness to defend those against transgression and other forms of misuse of democratic institutions (Weingast 1997). Misuse of institutions in

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2 In the present context individuals contribute towards a public good by refraining from misuse themselves and preventing it by others through self-regulation, whistle-blowing, demanding greater accountability from government officials, regulators, and other institution guardians, etc.

the private sector can be similarly prevented by means of self-regulation, which requires *inter alia* intensive communication and high level of consensus among operators and users of an institution (Haufler 2001).[3] These and other examples illustrate *complementarity* between institutions and social capital—the latter safeguards the former from misuse.

Russia and most of other post-communist nations have begun their transition to market democracies with depleted stocks of social capital, which is known to be adversely affected by a political history with predominantly despotic form of government (Putnam 1993; Tabellini 2008a). Surveys reveal low levels of trust and other indicators of social capital in Russia (Mersijanova and Jakobson 2007); moreover, the existing social capital often takes anti-modern forms, where the purpose of cooperation is to seek joint protection from an adverse institutional environment rather than to fix it (Rose 2000). Dislocation and hardship of often chaotic transition have further eroded social capital across the former Eastern Bloc (Aghion et al. 2009).

While the main focus and emphasis of post-communist transition have been on institutional reform, dramatic shortage of another important development ingredient—social capital—was often downplayed. Concurrency of the two processes—far-reaching institutional transformations and decline of social capital from initially low bases—jeopardized the outcomes of institutional reforms. In the dynamics that have been set in motion, institutions, values and behaviour are co-evolving (Tabellini 2008b; Aghion et al. 2009), possibly leading to low-level equilibria where social capital remains low and discredited institutions misused with impunity.

4 Government as institutional guardian

Failure of the society to police institutions against misuse calls for involvement of the government, which bears general responsibility for public good delivery. In the case of institutional reform, this role requires not only enactment of new institutions, but also enforcement of their rules. More stringent government regulation is a conventional response to low trust and diminished ability to maintain order by private means (Djankov et al. 2002; Aghion et al. 2009), and therefore shifting the burden of institutional protection from a society with low social capital to public agencies would follow this general pattern.

However, government's ability to protect institutions on behalf of a society that relinquishes such function is often limited; indeed, government performance in low-trust societies usually receives low marks (Putnam 1993; Aghion et al. 2009). Thus, in Russia the government's response, if any, to misuse of institutions has been almost invariably in restricting access to the institution both to those attempting misuse and to bona fide users alike. Such blunt regulatory tools often suppressed the institution instead of protecting it. For example, abuse of the NGO status for tax-evasion and money-laundering purposes (as well as allegedly for political means) resulted in a steep

3 A failure to prevent misuse through self-regulation is evident in Russia's post-secondary education, where the academic community has been notoriously unable to endorse and enforce a common stance on educational policies and remains deeply divided over higher education reform strategy in the country.

increase of reporting and regulatory requirements for Russian non-profits (prior to which they were also denied tax benefits that are normally accorded to such organizations). The remedy proved to be too radical as it led to a dramatic decline in the ranks of Russian non-profits, which found the cost of compliance with new rules prohibitively high. It is unclear whether the measure indeed contained the misuse of the NGO status, since there was a 'negative selection' at play—pseudo-NGOs that were able to successfully manipulate the old rules obtained comparative advantages over bona fide non-profits in navigating through the newly introduced stricter requirements. An equally heavy-handed reaction to the misuse in the 1990s of the Russian federal system was the cancellation of direct elections of regional governors, which essentially turned Russia from a federation into a unitary state.

Perhaps the most striking example of the limited ability of the Russian government to prevent misuse of institutions is the history of the Russian bankruptcy law. When such law was first introduced in the country in the early 1990s, it was rarely used due to excessively stringent pre-qualifications for bankruptcy proceedings. To facilitate the badly needed restructuring of Russian firms, the threshold was lowered, but that triggered massive response mainly from corporate raiders misusing the institution of bankruptcy. The grim choice between an institution, which is either defunct or vulnerable to massive misuse, was resolved in a yet another revision of the bankruptcy law which again tightened the requirements that ha to be met to initiate a bankruptcy. This attempt was not entirely successful, as it led to delays of bankruptcy cases initiated with good reasons, whereas raider attacks continued unabated, albeit by resorting to other chapters of the corporate law (Radygin and Simachev 2005).

Such reaction illustrates a common pattern of response to regulatory attempts to stop misuse of an institution by simply shifting misuse onto other institutions. This is a 'seesaw effect' (Acemoglu et al. 2008)—when a policy reform imposes constraints on some questionable actions, affected agents sidestep such restrictions by deploying alternative means to the same ends. Another illustration of this phenomenon is the increased reliance on intermediaries in dealing with government agencies, observed in Russia over the last several years. Demand for intermediaries' services went up in the aftermath of regulatory and administrative reforms that were expected to simplify and streamline official procedures and increase transparency and accountability of bureaucracy. An important objective of those reforms was to reduce corruption by increasing its risks. In response, corrupt officials resorted to misused intermediaries that offered 'institutional protection' by hiding bribes as flow-through in their fees (Polishchuk, Shchetinin and Shestoperov 2008). As a result, the reforms were 'defused' and corruption continued unabated.

A seesaw effect involving a misused institution was also present in the proliferation of 'corporate social responsibility' after a reform of intergovernmental finance that has reduced fiscal discretion and tax revenues of Russian regional governments. As it was argued earlier in the paper, Russian firms are often coerced by government officials into making social investments, and the misused institution of corporate social responsibility *de facto* restored fiscal discretion and revenue bases that regional governments were officially denied by the fiscal reform. However, such quick fixes are questionable surrogates of conventional fiscal tools, as they violate basic principles of wholeness (earmarked revenue sources are disallowed) and accountability of modern public finance, and 'soften' budget constraints of subnational governments. For private firms, arbitrary informal levies collected under the guise of corporate social responsibility

frustrate main objectives of the Russian tax reform: to make taxes transparent and predictable and lower tax rates while broadening tax bases. Finally, informal ad hoc agreements between businesses and bureaucrats also represent a seesaw effect bypassing the public administration reform that reduces government officials' discretion and subjects them to clearly stated rules.

One common cause of the above pathologies is low accountability of government to society. Indeed, restrictive regulations produce desired results in the middle range of political accountability—fully accountable officials refrain from questionable actions and properly perform their functions due to political incentives alone, whereas in case of low accountability, reform fizzles due to the seesaw effect (Acemoglu et al. 2008). Insufficiency of social capital adversely affects government accountability (Putnam 1993; Tabellini 2008a), and therefore when the misuse of institutions is not resisted at the grassroots, it is unlikely that government interventions will adequately fill the void.

Government actions (or lack thereof) are more likely to be driven by organized interests in the bureaucracy and private sector, and a political economy analysis provides further insight into the origins of misuse of institutions.

5 Political economy of misused institutions

Organized interests could be misusing captured institutions by transforming them from open-access private property-type institutions into extractive ones that earn rent for a group of privileged elite. When institutions of private property function as expected, they reduce rents for the elite (North 1990) and hence become targets of subversion. Established elites rely on exclusive ('inegalitarian') institutions to protect their privileges (Przeworski 2004), and since private property-type institutions are egalitarian in their nature, elites attempt to subvert them to further their needs (see, for example, Rajan and Zingales (2003); Polishchuk and Savvateev (2004); Acemoglu and Robinson (2008).

A useful way to think of this well-known phenomenon is to distinguish between *fixed costs* of accessing an institution, and *rents* that such institution affords once the 'entry fee' has been paid. For institutions of private property fixed costs are kept minimal, to ensure universal access, and consequently no rent accrues. Extractive institutions, on the contrary, maintain high fixed costs, thus allowing access only to the wealthy, but earn high rent to those qualified as 'club members'. The rent is transferred from the rest of society, and a deadweight loss makes such institutions socially inefficient.

Consider an institution (s,r), where s is the fixed cost, and r the rate of returns that accrues to assets of the institution's user. Assuming no income effect, if K is the capital endowment of an agent, his/her utility equals $U(s,r;K) = rK + u(s)$, where $u(s)$ is the payoff to non-capital assets, net of the fixed cost; function u is monotonically decreasing. For two institutional setups (s_1,r_1) and (s_2,r_2) such that $s_2 > s_1, r_2 > r_1$, sufficiently wealthy agents will always prefer the latter; furthermore, agents' preferences over (s,r) meet the single-crossing property and thus if an agent with capital K prefers (s_2,r_2) to (s_1,r_1), so will all other agents with $K' > K$. Capital thus serves as a sorting factor that tilts preferences of the elite in favour of inefficient institutions and

creates incentives for misuse.[4] When the institution is not misused, fixed cost is at its minimal (and socially optimal) level $s_0 \geq 0$, and the rate of return equals r_0. Misuse consists in raising fixed cost s above s_0 in other to increase r and earn rent of $r - r_0$.

Suppose that a two-class society consists of the elite and the mass, the former comprise share α of the unit continuum of agents and have per capita endowments of capital K_1; the mass's share of the population is $1 - \alpha$ and their capital endowments are $K_2 < K_1$ each. The total stock of the capital in the economy equals $K = \alpha K_1 + (1 - \alpha)K_2$. A misused institution (s, r) with $s > s_0, r > r_0$ entails aggregate welfare losses:

$$\Delta = r_0 K + u(s_0) - rK - u(s) > 0. \quad (1)$$

If the elite prefer misuse, their valuation of the two institutional regimes runs in the opposite direction:

$$rK_1 + u(s) > r_0 K_1 + u(s_0). \quad (2)$$

These two conditions can be restated as:

$$(r \quad r_0)(K_1 \quad K) > \Delta > 0. \quad (3)$$

In other words, the elite prefer misuse if the rent they earn on their capital in excess of the economy-wide average per capita level exceeds average per capita losses of welfare caused by the misuse.

The above theory of misuse can be illustrated by the subversion of entry regulation mentioned in Section 2, where the purpose of high barriers is to deter entry by holders of small capital assets and thus increase payoffs to the capital of the wealthy.[5] As in De Soto (2000) we assume that those unable to afford high entry costs deploy their assets in the informal sector, where returns are much lower; for simplicity, nil. Suppose that the economy's production function $Y = F(K, L)$ satisfies the standard neoclassical properties, and that in addition to capital assets, each agent possess one unit of labour. If the fixed cost is set at the socially optimal level,[6] all capital is invested in the official sector of the economy:

$$K_2 F_K(K, 1) > s_0. \quad (4)$$

If the purpose of misuse is to keep small resource owners out, then s should be set equal to $K_2 F_K(\alpha K_1, 1)$, in which case the entry cancels off the returns to the capital endowment of a small owner, and entry to the official sector does not produce any

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4 This can be interpreted as *increasing returns to scale* in rent-seeking (Murphy, Shleifer and Vishny 1993); see also Rajan and Zingales (2003) and Polishchuk and Savvateev (2004).

5 Djankov et al. (2002) consider two possible patterns of the regulation of entry capture: by the bureaucracy operating the entry process (a 'tollbooth' view) and by vested interests which are based outside the government but can influence the latter. Our analysis follows the second view.

6 Arruñada (2007) cautions about the push to reduce entry barriers below what is required to serve their intended purposes.

economic benefits. After small owners' exclusion, those in the elite earn the payoff $(K_1 - K_2)F_K(\alpha K_1, 1) + F_L(\alpha K_1, 1)$, whereas when $s = s_0$, their payoffs are $K_1 F_K(K, 1) \mid F_L(K, 1) \quad s_0$. One can check (invoking concavity of the technology), that due to (4) social welfare decreases when s goes up from s_0 to $K_2 F_K(\alpha K_1, 1)$:

$$\Delta = F(K, 1) - s_0 - \left(F(\alpha K_1, 1) - \alpha K_2 F_K(\alpha K_1, 1)\right) > 0, \tag{5}$$

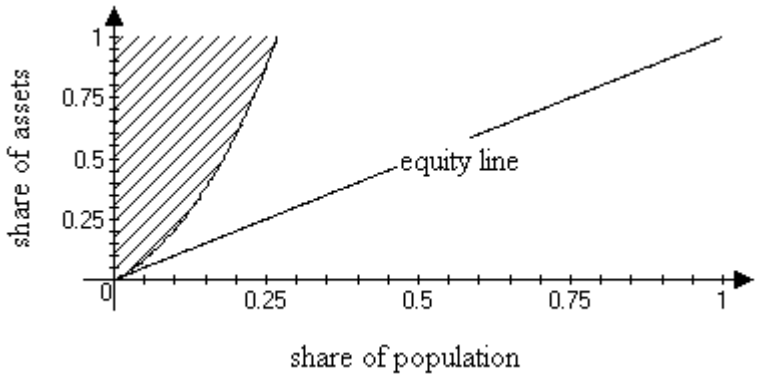
and the condition (3) in the present context is as follows:

$$(K_1 - K)\left(F_K(\alpha K_1, 1) - F_K(K, 1)\right) > \Delta. \tag{6}$$

Notice that the condition (3) (as well as its special case (4)) holds only if distribution of the capital in the economy is sufficiently inequitable (Figure 1 illustrates this for the Cobb-Douglas technology $F(K, L) = \sqrt{KL}$; the horizontal axis shows the share α of the elite in the total population, and the vertical one, the share $\alpha K_1/K$ of the elites' assets in the total capital stock of the economy; the shaded area comprises combinations of the above parameters for which the elite would favour excessive entry barriers). Indeed, misuse of private property-type institutions could benefit a particular interest group only in unequal societies—otherwise every group will bear its share of aggregate welfare losses and will thus be opposed to the misuse.[7] This is consistent with the general conclusion that extractive institutions (often obtained through misuse through capture of institutions intended to enhance economic efficiency) are likely to emerge and be sustained in societies with profound economic inequality (see, for example, Engerman and Sokoloff 2000).

With a weak civil society, the elite are likely to prevail in shaping government policies due to their advantages in resolving the collective action problem (Olson 1965) and the ability to deploy for lobbying purposes vast resources that they control. Elite dominance in public policymaking explains not only the above-described misuse through capture, directly benefiting the elite, but also other kinds of misuse at the grassroots, to which the elite—and hence the government—are simply indifferent.

Figure 1
Incentives to misuse entry barriers



7 For more on the role of inequality in shaping preferences in favour of inefficient institutions, see Polishchuk and Savvatev (2004).

Indeed, various individuals value the same institution to different extents: for some, the institution could be nearly vital, for others, barely noticeable and almost never used. Thus, elite's immediate needs in services provided by NGOs (social programmes and safety nets, protection of social, political and economic rights, etc.) are obviously not particularly acute. The same is true about domestic institutions of post-secondary education and health care, which the powerful and wealthy ignore by sending their children to foreign universities and obtaining treatment at clinics abroad, and—with some caveats—about courts and financial markets to which the elite can also find foreign and/or private alternatives.

Furthermore, even if general-purpose institutions which are valued by the society at large are also of some value for the elite, the latter have more immediate and overarching needs in club goods that are essential for the elite but of little immediate significance for the rest of society. Thus, economic assets controlled by the elite could require specialized public factors of production; one can think, for example, about an economy with a large resource sector dominated by the elite, and the latter would be concerned about pipelines and other components of the resource industry infrastructure. To make the discrepancy between institutional needs of the elite and the rest of society particularly stark, assume, as in (Acemoglu and Robinson 2008) that the elite and the mass take utility in *different and non-overlapping* types of public goods. In that case, the elite would not waste its political resources on policing institutions that they don't value, and will instead use its influence to maximize the supply of the club goods. As a result, general-purpose institutions will be misused with impunity because elite's influence leads to re-deployment of public resources, including government's oversight capacity, from the open access institutions to the club goods.

A menu auction model (Grossman and Helpman 2001) could be used to describe the outcome of such bias. Let G_1 and G_2 be supplies of institutions-club goods and institutions-public goods, respectively, which are funded from tax revenues collected at a flat rate t. Aggregate social welfare is as follows: $W(t,G_1,G_2)=(1-t)[Y_1(G_1)+Y_2(G_2)]$, where the part $Y_1(G_1)$ accrues (before taxes) to the elite and depends on the club goods G_1, and $Y_2(G_2)$ to the mass and depends on the availability of the public goods G_2. Government policy (t,G_1,G_2) must satisfy the budget constraint $G_1+G_2 \le t(Y_1(G_1)+Y_2(G_2))$. If there is no lobbying, the government chooses its policy by maximizing W subject to the budget constraint, and supplies both production inputs at socially optimal levels G_1^0, G_2^0 such that $Y_i'(G_i^0)=1, i=1,2$.

Suppose now that the elite are organized in a lobby and offer the government a contribution $C(t,G_1,G_2)$ depending on a policy choice, whereas the mass are unable to solve a collective action problem and stay unorganized. In that case, the government chooses its policy by maximizing $W+aC$ with some $a>0$ (characterizing government's susceptibility to influence), subject to the same budget constraint. In equilibrium lobby's contribution function is *locally truthful* (Grossman and Helpman 2001), i.e., has the same marginal rates of substitution between policy instruments as in the lobby's utility function $W_1=(1-t)Y_1(G_1)$. Equilibrium quantities of production inputs $G*_1, G*_2$ immediately follow from this property, and since the elite's preferences now by proxy enter the government's objective function, one can easily check that inequalities $G*_1 > G_1^0, G*_2 < G_2^0$ hold. It means that elite's club goods

compete with general-purpose institutions for tax revenues (which proxy in the model government resources available to supply and sustain an institutional setup) and thus *crowd out* the latter. This translates into a lack of protection from misuse of the private property-type institutions.

Similar conclusions obtain under a different assumption, when the elite do not lobby the government from without, but are part of the ruling class and choose from within government policies with regard to institutions in accordance to their economic interests. A model based on McGuire and Olson (1996) shows that if the ruling class has its economic assets concentrated in a part of the economy that shows low sensitivity to the supply of institutions-public goods, and requires specific club goods-type production inputs, this, too, distorts the choice of the government away from the social optimum, and leaves private property-type institutions neglected and open to misuse.

A noteworthy result of such analysis concerns the impact of market interests of the ruling class on choices made by a politically unaccountable government. If the ruling class has no direct ownership of economic assets and considers private sector only as a taxbase, public production inputs (this includes institutions) will usually be undersupplied in comparison with social optimum, and tax rates will be excessively high. McGuire and Olson (1996) show that when the ruling class directly owns some production assets, it could improve government policies leading to lower tax rates and increased provision of the public goods. However, in the present two-sector context this conclusion is not the case: when the assets of the ruling class are only in the first sector, tax rate will indeed go down, and provision of the club goods G_1 will increase, but the provision of the public goods G_2 will be *lower* than in the benchmark case of the ruling class without market assets. The intuition behind this result is as follows: the ruling class still considers the part of the economy it does not own as merely a taxbase, and the reduction of the tax rate (out of concern about the ruling class's own market assets) diminishes the incentives to spend public funds on production inputs that expand such tax base (for more details, see Polishchuk 2008b). This conclusion corroborates the findings in (Robinson, Torvik and Verdier 2006) that 'resource booms' prompts ruling elites to vigorously pursue the 'extraction path' in a close to socially efficient pattern while misallocating resources in the rest of the economy—in our case, by withdrawing support from open access institutions making them vulnerable to misuse.

6 Implications for reforms

Massive misuse of newly established institutions was an unexpected outcome of reforms, not unlike other 'surprises' of transition (Roland 2000). A major reason for such outcome was the complementarity between institutions and culture: the dearth of social capital in post-communist societies left institutions unprotected at the grassroots, and failed to produce strong demand for government's enforcement of rules preventing misuse. Politically organized and influential groups among the elite were either indifferent to misuse of many institutions or, worse yet, perpetrated it.

While early on in the transition misuse of institutions was perhaps inevitable due to the overall disorganization in the economy and society and general proliferation of opportunistic behaviour and rent-seeking (Polterovich 2007), in some countries, including Russia, such deviations became chronic, developed their own momentum, and

were subsequently reinforced. Misuse of institutions was sustained by the continued decline of social capital, increasing distrust and atomization in the society, and growing disappointment in the new institutions and indifference to their fate. This dynamics refuted the expectations that globalization would force societies to adopt modern culture, which is 'no longer a matter of choice' (Porter 2000: 27). Instead, it proved that norms and values comprising social capital exhibit strong inertia and are susceptible to short-term negative shocks (Tabellini 2008b).

Another aggravating trend was deepening socioeconomic inequality, which was conducive to degeneration of private property institutions into extracting ones. Finally, a powerful contributing factor was incomplete reform. Indeed, misuse of institutions is often facilitated by gaps in the institutional setup: missing institutions could have provided checks and balances preventing misuse of those institutions that are already in place. Thus, well-established corporate governance and effective and impartial court system prevent misuse of the institution of bankruptcy. A strong and yet constitutionally constrained federal government is required to maintain 'market-preserving federalism' and prevent misuse of decentralization at the subnational level, such as 'beggar-thy-neighbour'-type policies detrimental to economic growth (Blanchard and Shleifer 2001; Polishchuk 2001); a well-developed system of political parties works to the same end. Political competition, free media and other transparency-enhancing institutions serve to prevent institutional capture by vested interests, etc.

An incomplete institutional regime could emerge in a process of gradual reform where new institutions are supplied in a particular sequence and over a significant period of time. Gradual reforms present an alternative to radical ones, when the required institutions are established quickly and nearly simultaneously. Both strategies have their strengths and weaknesses, extensively debated in a vast literature on the subject (see, for example, Roland 2000; Polterovich 2007). Gradualism is usually justified by difficulties of implementation of multiple reforms across a broad front, as well as by benefits of learning and if necessary adjustment of earlier blueprints. One of the dangers of a gradual approach is that in the interim it could create opportunities for misuse of institutions already in place. Hellman (1998) argues that political and business elite are better able to extract rent from unfinished reform and thus stay in the way of reform completion, protracting an institutional hiatus. Our analysis shows that rent from half-reformed economies can be extracted through misuse of earlier supplied institutions; in fact, misuse of institutions and incomplete reform feed upon each other. This can once again be illustrated by the mistreatment of corporate social responsibility: poor protection of property rights, typical for incomplete reforms, makes businesses susceptible to government coercion. Vice versa, unfounded expectations that socially responsible companies should maintain their workforces irrespective of market conditions are likely to delay economic restructuring and modernization of social safety nets (Polishchuk 2009).

Once misuse of institutions has become entrenched, it is difficult to reverse. One can hope that development itself creates more enabling conditions for institutions to function properly, for example, through accumulation of human capital (Lipset 1960; Glaeser et al. 2004). This kind of scenario, however, cannot be assured, given the danger of 'institutional traps' (Polterovich 2007) and commonly observed 'invariance' to reforms of institutional setups adverse to development (Acemoglu and Robinson 2008); it is noteworthy that such invariance can be sustained precisely through misuse of institutions that are expected to eliminate *ancien régime*. Furthermore social capital is

known to be difficult to instil and nurture by government and donors who at best could support and augment 'bottom-up production of norms and networks in non-distorting ways' (Keefer and Knack 2005: 772).

If the damage caused by misuse exceeds the benefits that the institution still produces, and if no reliable means to prevent misuse are available, then not introducing such institution is the second-best choices (Glaeser and Shleifer 2003). A palliative solution could be to design institutions 'misuse-proof' so that '[they do] not depend on absent or weak institutions and [are] insulated from or adapted to perverse institutions as far as possible' (Shirley 2005: 630). This reinforces the general dictum that best-fitting institutions for transition and developing countries should be designed to reflect local idiosyncrasies, including the danger of misuse.

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