



# Economic Pathology and Comparative Economics: Why Economies Fail to Succeed<sup>1</sup>

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Understanding why economies do not succeed is at least as important as understanding success. The study of failure is focused on the stability of institutions that inhibit good performance, the *Northian Conundrum*. Policies that seem perverse may fit into a larger institutional environment. This explains the persistence of dysfunctional institutions. The key to effective reform is to understand the underlying logic of the system. I use the phenomenon of Russian viability insurance as an example.

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## INTRODUCTION

It is an honour to present this first Presidential Address of the ACES. I feel humbled, and more importantly, pressured to not end this tradition by boring everyone out of their minds. The rare opportunity to offer you my view on how comparative economics should develop and be pursued must be tempered by the fear leaving this new tradition stillborn. I recognise that such

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an address from any of my distinguished predecessors would have been a perfect way to launch this tradition; unfortunately, however, I am the test case.

Rather than present a set of methodological dicta, I want to explore a fundamental problem of transition economics, peering into the black box of institutions. To a large extent, what we do as transition economists, is study how institutional arrangements deflect economic performance from the trajectories that economic fundamentals would otherwise direct. If development economists and economic historians are tasked with explaining why economies grow rich, in comparative economics, we are most focused on why economies fail to do so.<sup>2</sup> The problem is not to explain economic collapse;<sup>3</sup> I suspect that most of us would argue that even the demise of central planning was not the result of economic collapse but of political pressures that accompanied deteriorating economic performance.<sup>4</sup> The task is thus to explain why opportunities for better performance are not exploited.

The important skill developed by comparative economists is understanding economic behaviour in distorted economies. There are two distinct, yet compatible, approaches that have been pursued. *Economic Pathology* focuses on the distortions that prevent economies from performing at optimal levels.<sup>5</sup> The command economy, for example, suffered from distortions in pricing, lack of property rights, soft-budget constraints, etc. We studied the consequences of this, and how it impacts on economic behaviour and performance.<sup>6</sup> *Comparative morphology* on the other hand, studies the logic of the system and how it evolves. Thus, to continue with the command economy, comparative morphology asks why this system was so difficult to reform, by focusing on the factors that held the system together. In this way, it

<sup>2</sup> At one time, perhaps comparative economics studied alternative ways of growing rich, but today I think that is no longer the case, at least for most of us.

<sup>3</sup> Recently Diamond (2004) has written on the collapse of societies, focusing on environmental causes of such events. What is interesting to transition economists, however, is that in all his cases the role of ideology is paramount, leading to an inability to adapt to changes.

<sup>4</sup> This is partly the result of Stein's law: 'If something cannot go on for ever it will stop'. Understanding why Argentina has failed to live up to its promise is perhaps as important as determining why China has thrived.

<sup>5</sup> Pathology is the study of sick organisms – definitely those whose self-correction mechanisms are too weak to overcome maladies.

<sup>6</sup> This is a rather conventional way to analyse the Soviet system, as a sick economy. Alternatively, one could treat it as a different species, evolving under its own non-market logic. Different species are much more difficult to treat (reform) than sick economies. There is no drug that can turn a dinosaur into a mammal. For an evolutionary analysis of transition economics, see Ickes (2003).



Q1 is possible to understand the forces that drive the evolution of the system. I hope to show why this is important by the end of this talk.

What I want to suggest is that by studying failed paths we can peek closer into the institutional black box. Studying growth failures is at least as valuable as growth miracles. With miracles, the problem is to assess the relative importance of many fortuitous events. Failures may teach more.<sup>7</sup> The Tolstoy axiom about marriage is *apropos* – ‘Happy families are all alike; every unhappy family is unhappy in its own way’. At least for economists, there appears to be one path to successful economic development. Failure, however, is characterised by great diversity.

Despite the diversity in which failure (or postponed success) appears to be displayed, there may be some lessons that can be learned. In this essay, I will focus on the role of dysfunctional institutions, and in particular, how they function in times of great upheaval. I will argue that policies that appear to be perverse, when examined in isolation, display a certain logic when studied in terms of the institutional environment. When properly understood, the persistence of bad policies becomes more comprehensible.<sup>8</sup>

## FAILURES AND THE NORTHIAN CONUNDRUM

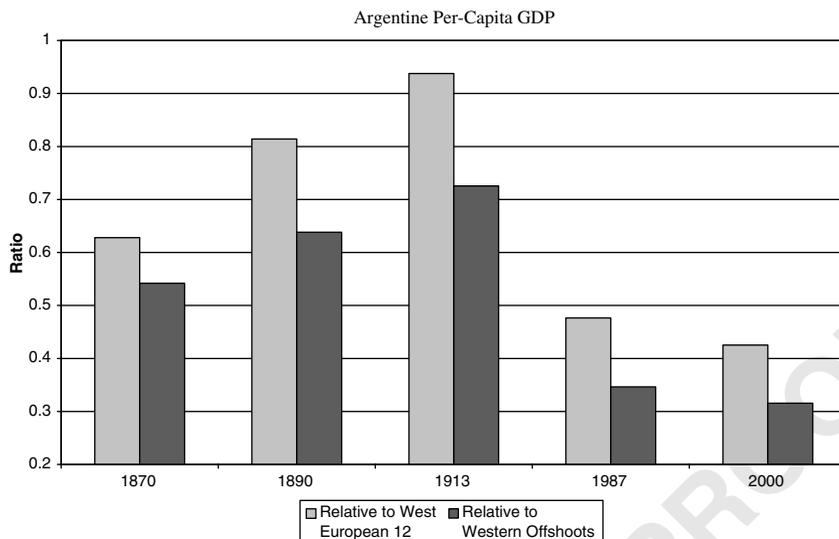
Consider the case of Argentina. Endowed with resources, a relatively educated labour force, immigration and high capital inflows at the turn of the century it was set for prosperity. In the previous 30 years Argentina had been catching up, as is evident in Figure 1. By 1913, Argentina’s GDP per-capita was 90% of the Western European 12% and 72% of the Western Offshoots.<sup>9</sup> By 1987, these ratios were 47% and 34%, respectively, and by 2000, the figures are 42% and 31%. Argentina is clearly a case of success foregone. If we can understand the relative significance of factors that prevented prosperity, we will learn much about the determinants of growth. And as institutional failures seem critical in this regard, we are perhaps well situated to do so.

We know in some general sense what happened in Argentina. Economic policies that raised the cost of capital lowered investment. Policies that promoted redistribution over growth further retarded growth. Protectionist

<sup>7</sup> Medical students study sick people after all. Residents work at hospitals not health clubs.

<sup>8</sup> It may be hoped that greater comprehension provides the key to effective reform. I believe that, but I will not make that case in the present essay.

<sup>9</sup> The Western European 12 is Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, Sweden, Switzerland, and the UK. The Western Offshoots are Australia, Canada, New Zealand, and the US.



**Figure 1:** Argentine GDP per-capita in perspective (Source: Madison, 2003)

policies reduced competitiveness. Slow growth and fiscal deficits created a debt overhang. Essentially, Argentina suffered a succession of policies that inhibited rather than fostered economic growth. The important question, however, is why this could persist for three-quarters of a century? Why did not the costs of these policies lead to a correction? This is a case of many pathologies, but viewed in this way we are left simply puzzled as to their persistence. If these policies led to such sustained poor performance, why were they not changed?

When we view the Argentine case from the vantage point of morphology, however, the focus is on the stability of the system. In many situations, stresses create forces that overcome the initial problems.<sup>10</sup> Crises are often the catalysts for economic reforms. However, in some economies the negative feedback from bad policies is insufficient to break out of the economic malaise. The question is why are these states evolutionarily stable? What forces prevent individuals and institutions from an efficient response? Clearly, Argentina was, at no time during the 20th century as disadvantaged as South Korea in the 1950s.<sup>11</sup> Yet somehow the coordination failures in the Argentine were not overcome.

<sup>10</sup> Galor and Moav (2005) study how increases in higher extrinsic mortality leads to an increased prevalence of somatic investment, which leads to greater health in the long run.



What happens in these circumstances is that institutions develop that support the status quo, and even develop further to reinforce. The following is the Northian conundrum:

The organizations that develop in this framework will become more efficient – but more efficient at making the society even more unproductive and the basic institutional structure even less conducive to productive activity. Such a path can persist because the transaction costs of the political and economic markets of those economies together with the subjective models of the actors do not lead them to move incrementally toward efficient outcomes.<sup>12</sup>

We typically speak of inefficient institutions as those that hinder growth. Narrowly viewed, however, they are very efficient at promoting their own ends. What we really mean is that they are socially inefficient. As North describes, these organizations are efficient in terms of their own survival at the same time that they are making society less productive.<sup>13</sup>

To some extent this is a classical question of comparative economics. Recall the analysis of economic reforms in Soviet-type economies. One important lesson was that reforms that attacked the fundamental core elements of the command economy were rejected. Vladimir Kontorovich’s analysis of the 1965 reforms is a great example.<sup>14</sup>

The standard approach to such problems in economics is first to consider differences in economic fundamentals. For example, we list the endowments and technology available in an economy, and then we examine the equilibrium allocations. When we observe that performance differs, we examine what restrictions on economic activity account for this. Long before the world had an information-superhighway, flows of capital and ideas meant that differences in technology *per se* were unlikely to account sufficiently for such differences. We are typically left with differences in institutions to explain why capital earns a higher return in the US than in Niger, in contrast with what diminishing marginal productivity would suggest.<sup>15</sup>

<sup>11</sup> In 1950, for example, South Korean GDP per-capita was 29% of the Argentine level. Of course, South Korean performance was affected by war in 1950. However, if we look at 1913, we see that the ratio was 32% and in 1939, it was 31%. By 2000, on the other hand, it was 167%!

<sup>12</sup> North (1991, p. 9).

<sup>13</sup> The contrast is between internal efficiency and social efficiency.

<sup>14</sup> Kontorovich (1988).

<sup>15</sup> Output per worker in the US (in 2000) was 38 times that in Niger. If the aggregate production function is Cobb–Douglas and capital’s share in output is  $\beta$ , then the marginal product of capital in country  $i$  is  $r_i = \beta A^{1/\beta} y_i^{(\beta-1)/\beta}$ , where  $y_i$  is per-capita output and  $A$  is the level of TFP. Now suppose there are no institutional differences between Niger and the US, so  $A$  is identical in both countries, and let  $\beta = 0.4$ . Then  $\frac{r_{\text{Niger}}}{r_{\text{US}}} = \left(\frac{y_{\text{US}}}{y_{\text{Niger}}}\right)^{(\beta-1)/\beta} = (38)^{1.5} = 234$ . However, if the rate of return was so much



Yet what do we mean by institutions? In a circular way, we mean those restrictions that prevent the efficient use of resources. Thus, the importance of institutional differences is typically derived as a residual; *a la* Hall and Jones, for example, we collect information on inputs across countries and assuming that technology is common, we can then explain the differences in per-capita output as the result of TFP differences. Of course, residuals thus estimated are somewhat of a black box. We can try to find proxies for these differences, and much interesting work does this. However, such comparative exercises cannot really tell us how institutional differences result in differing performance, and that, of course, is what we really want to know. The problem is that we have little or no theory of institutional determination – that is, why certain countries have such dysfunctional institutions,<sup>16</sup> how such institutions actually operate, and why they are so persistent.

One way to think of institutions is as social mechanisms that deal with the consequences of change. They act as constraints on economic choices above those provided by tastes and technology. Of course, there are good and bad social mechanisms, as judged by the costs imposed. Socially efficient institutions smooth the process of economic change by weakening resistance to it, primarily by compensating losers in ways that minimise distortions.<sup>17</sup> Socially inefficient institutions prevent change by protecting losers and stifling change. In an environment with socially efficient institutions adaptation to new circumstances is facilitated. Socially inefficient institutions, on the other hand, facilitate the survival of organizations *within its own* framework.<sup>18</sup> In the limit they may impede growth altogether.

## DYSFUNCTIONAL INSTITUTIONS AND PERSISTENCE

The question, of course, is what determines which sets of institutions arise, and why they persist. In particular, why are some economies unable to shed inefficient institutions over some reasonable horizon? The answer to this

higher in Niger, we would expect capital to flow from the US to Niger, not the other way around. This is sometimes referred to as the Lucas Paradox. See Lucas (2002, pp. 63–64).

<sup>16</sup> There is some theory to explain the dissemination of good institutions – for example, the settler mortality theory of Acemoglu *et al.* (2002), and the related endowments theory of Engerman and Sokoloff (1997).

<sup>17</sup> This terminology is a bit loose. By efficient, here, I mean socially efficient, as it relates to social welfare. Alternatively, institutions can be efficient in adapting to given circumstances and resistant to change, even at the expense of social welfare.

<sup>18</sup> Moreover, some institutions that may be socially efficient in one environment may become dysfunctional when circumstances shift. An interesting example is considered by Avner Greif (1994), in his examination of the Maghribi Traders.



question explains why some economies – Argentina, Russia to take two notable examples – squander great advantages. Surely, it is as important to explain such failures as to explain success stories.

Among the factors that play a critical role here is that redistribution is allied with incumbent protection. Some agents have prior claims – but not property rights – to resources that, after reforms, have higher alternative uses. Rather than allow these resources to be reallocated, they struggle to preserve the old allocation. We can accept that all incumbents try to protect their rents. Economic progress occurs as the resistance of incumbents is overcome. The key is to understand why some incumbents are more successful than others. In some economies, incumbents are able to tie their own protection to policies that obtain social support. The example that I will discuss in some detail is, what Cliff Gaddy and I call Russian viability insurance. However, some further preliminaries are required.

Dysfunctional institutions primarily operate on some *status quo preserving* redistributive or protectionist mode.<sup>19</sup> Since they resist efficiency-enhancing change (adaptation) these institutions are necessarily costly to society. The persistence of such redistribution must thus be related in some way to the extent of its inefficiency – how greatly it distorts economic activity, and on the resources needed to support it. Gregory Grossman argued in the ‘Economics of Virtuous Haste’ that Soviet resource abundance allowed inefficient economic policies to be pursued with the consequences postponed – had resource abundance been less the costs would have been apparent much sooner.<sup>20</sup> Thus, we might assume that in economies where there is greater resource abundance there are greater opportunities for inefficiency. Three observations are in order.

- It is important that the state be able to buy off interests to prevent a reaction. That means that there must be sufficient wealth accruing to it – it cannot be such inefficient redistribution that the state is too weak to fight reaction to it.
- This might also suggest why resource abundance is particularly important. In such economies it is possible to get control of wealth production with less interference than in more diversified economies. Operating a protection-type economy causes negative feedback in the more diversified economy. Of course, in the long run, centralised control of resources might deter

<sup>19</sup> Not the irony of using the term ‘redistributionist’ in a pejorative way, as is typical in most discussions. In fact, the market is much more redistributive. It is the non-market alternative that is protecting existing returns. The Russian Virtual Economy is the paramount example. We resort to the term redistribution because we think of the market allocation as the benchmark. However, in transition, it is really the opposite since we inherit the non-market claims to resources and rents.

<sup>20</sup> Grossman (1983).



exploration and result in poor performance. However, in the short run, there are fewer adverse consequences for economic activity.

- This also explains why in such an economy the state wants to control entry of new economic activity. The biggest threat to central control is the emergence of alternative sources of economic wealth creation.

Dysfunctional institutions are most likely to become problematic when large structural changes are taking place.<sup>21</sup> It is precisely in such circumstances that incumbents of all types require protection, and with the potential losses being so high, the demand for institutions that can provide protection is at its highest.<sup>22</sup> It is the number of losers and the perceived size of the potential *net* losses that matter. If the demand for redistribution is high – as in Russia – then there is political support, which reduces the cost to the state of adopting and enforcing a dysfunctional regime. However, what determines the supply price of these institutions?

The supply price of such institutions depends on how much value there is to redistribute. We expect it to be much easier in a resource-abundant economy. Another important factor is the security of existing property rights. Suppose that the initial claims to wealth are tenuous to non-existent, as was the case in Russia in 1991–1992, then it is much easier to make a deal to expropriate some of this wealth to use for redistribution.<sup>23</sup> The perceived security of property rights is thus a key determinant of the supply price of dysfunctional institutions. This seems like a circular argument – weak property rights are explaining the low supply price of bad institutions. However, tenuous claims to wealth in 1992 Russia were a legacy of the previous regime; this was precisely when property was being redistributed, so claims were exceptionally weak.

If we turn to redistribution, we might posit two modes that it may take. In the standard stationary bandit model, the state expropriates some of social product as the return to its monopoly of power. The problem for the state is to limit its expropriation of wealth to that level consistent with maximising the present value of revenues. Presumably, the state provides law and order and

<sup>21</sup> When these institutions first formed, they may have even been a socially efficient adaptation. It is the change in the economic environment that typically renders them socially *inefficient*.

<sup>22</sup> Moreover, it is precisely in such periods of change that mechanisms for compensating the losers are most difficult to implement. Were this not the case there would be no need to resort to inefficient means to protect incumbents. However, if setting up compensation schemes is difficult even in normal times it is especially so when large political and economic changes are taking place.

<sup>23</sup> When property rights are tenuous and the distribution of wealth is skewed, wealth-holders fear that redistribution (nationalisation) may take place. Hence, they will be willing to use their wealth to buy off those who might support redistribution. Gaddy and I used the metaphor of the *privatization lottery* to explain this in chapter 5 of Gaddy and Ickes (2002).



some other functions that legitimate – or pose for legitimacy – its position. However, in this case the state is seen as a burden that is tolerated if the costs are not excessive.

In the second model, the state expropriates, in part, on behalf of some social forces in society. In this case the stationary bandit is not a force apart from society. I have in mind here a state participating in a social bargain with some forces in society, such that it is able to expropriate resources as reward for its provision of protection from market forces. The state is expropriating and preserving elements of the *status quo*, simultaneously. This second mode is likely to be much more stable once established. It is also likely to be much worse for economic growth and welfare.

If we compare these two roles for the state, we note that in the standard model the state is primarily a levier of taxation. Its interests are consistent with maximisation of the value of production, as this enables a maximum of revenue to be obtained. In the latter model, however, the state alters *allocation*. Its role in the social bargain is to prevent or slow down changes that market forces would bring about. Hence, by nature it interferes with normal market forces and thus impacts on economic performance.

To an economist the *modus operandi* of the state in this second role is singularly inefficient. Better to use tax revenues to compensate the losers from change than to prevent market forces from operating. Yet, states rarely operate in this way even in the most advanced economies. Partly this is due to the difficulty in ascertaining, *ex ante*, who will be hurt and by how much. In addition, there is the feeling on the part of some that compensation will not be forthcoming – a lack of credibility weakens such schemes. However, this hardly seems sufficient to explain the prevalence of such inefficient schemes.

Perhaps what we should ask is whether the government is better off with the efficient scheme? Or can it obtain more resources by holding the losers together as a political force? Potential resources are always greater with the efficient mechanism, but this hardly supplies an answer to this question. First, because government is not really a homogeneous actor, there may be conflicts among government officials whose interests vary. Second, the interests of some government officials may be enhanced by inefficiency, especially when combined with non-transparency, which allows for greater ability to compensate officials. The specific answer apparently differs across time and place; else, we would not observe such variety in performance. Understanding why the inefficient scheme may be preferred is thus an important step.

Resistance to change is not found only in transition, of course. Economic history, especially since the industrial revolution is filled with examples



where innovations were initially met with considerable resistance.<sup>24</sup> Perhaps, most interesting for us is the reaction to Jenner's discovery of the smallpox vaccine. He was told 'not to risk his reputation by presenting to this learned body anything which appeared so much at variance with established knowledge and withal so incredible'. As Mokyr (2002, p. 266) describes it:

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Jenner's famous discovery of the smallpox vaccine ran into the opposition of the inoculators concerned about losing their lucrative trade... The source of the vaccine, infected animals, was a novelty and led to resistance in and of itself: Clergy objected to the technique because of the 'iniquity of transferring disease from the beasts of the field to Man'... Cartoonists depicted people acquiring bovine traits, and one woman complained that after his daughter was vaccinated she coughed like a cow and grew hairy... Despite all this, of course, the smallpox vaccine was one of the most successful macroinventions of the period of the Industrial Revolution and its inventor became an international celebrity.<sup>25</sup>

The important point of modern economic growth is that such resistance can be overcome. If the gains from change are sufficiently large, we expect that the winners can compensate the losers. But this does not always occur; that inefficient institutional arrangements often persist is, of course, the Northian conundrum.

Acemoglu (2003) has examined why parties are often unable to reach mutually advantageous political agreements - his theory focuses on the inability to write binding agreements.<sup>26</sup> This makes incumbents reluctant to give up power since they know that once they do so the commitments they have been promised can easily be reneged upon.<sup>27</sup> Owing to this such changes often require the incumbents to become isolated from society. The greater this isolation the less able they are to protect their incumbent position. Hence, elite incumbents seek to marry their interests with other groups in society to preserve their position. Historically, this was a class of lords or clerical interests. However, often it is with some group of the masses. In the

<sup>24</sup> In a sense innovations are very much like economic reforms. They are both shocks that if implemented, lead to improved economic performance. However, both also have distributive impacts.

<sup>25</sup> There was similar resistance to the germ theory of disease, first proposed by Giovanni Bonomo in 1687, yet not accepted by physicians until 1886 (Mokyr, 2002, p. 227) with the observed success of diphtheria vaccine.

<sup>26</sup> Acemoglu (2003).

<sup>27</sup> For our purposes, an interesting example would be oil companies. Before the oil is discovered, countries are willing to sell the rights at quite favourable terms. Afterwards, nationalisation often occurs. Notice that in this case the oil company actually contributed to the creation of value, whereas rulers are much less responsible for the wealth they seek to preserve.



**Q3** case of Russia, the presence of a large class of potential losers from change alters the calculus. It is not really necessary or often likely that the average citizen will lose from change. Rather, what is crucial is that those agents likely to lose can easily calculate what will happen to them, while the beneficiaries of change are much more uncertain. Think of the smallpox vaccine example. The potential gains were massive, but who could really anticipate this? However, the losers – the inoculators – were quite clear about their position.

What saved the smallpox vaccine was the fact that experiments on small groups could prove success, and this could diffuse throughout society. Demonstration effects work to change the views, especially of the potential winners. The situation is much different for economic change. Experiments are infrequent, and successful change requires broad acceptance.<sup>28</sup> Better performance abroad partially takes the place of experiments, but too often this is disregarded as owing to special circumstances and the perceived threat to national culture.<sup>29</sup> The important point is not whether, in fact, there are special circumstances or a threat to national culture, but that these arguments are effectively used by incumbents to protect themselves from reforms that have demonstrated themselves elsewhere. It is much harder to dismiss successful scientific experiments.

I think that one reason why the resistance to change is so effective is cultural inheritance. There are some deeply hardwired attitudes. In many countries, Russia is a good example, resources are viewed as wealth to be distributed. The attitude towards wealth is that it is strictly zero-sum and the issue is division not creation. In other countries, the US is a good example, resources are a base on which industries can develop.<sup>30</sup> Some of the difference between the Russian and US policies towards resources is due to these cultural attitudes. Resources can be a curse or a blessing dependent upon the cultural beliefs and the institutions that they foster.

To further analyse the role of institutions that prevent economic success and the social support for them, I turn to the Russian example.

<sup>28</sup> This is another way of noting that economic reforms often require a critical mass to be effective – hence, there is the problem of coordination failure. This problem is much less likely with regard to other types of innovations. I can obtain the benefits of the vaccine even if I am the only member of the family to do so. Indeed, in that case the lesson may be learned much quicker.

<sup>29</sup> There is also the important difference that experiments with regard to a vaccine can be conducted on volunteers, with little or no side effects for the sceptical. Economic reforms can rarely be isolated in that way, as the study of Soviet partial reforms adequately taught us.

<sup>30</sup> Gavin Wright has done important work on this. See Wright and Czelusta (2002).



## RELATIONAL CAPITAL AS AN INSURANCE CONTRACT

Now I turn to an example of a socially inefficient institution that has evolved over time, and has become ‘more efficient at making society even more unproductive.’ Relational capital is an asset that agents and enterprises accumulate to protect themselves from market outcomes. It augments the value that could be produced from standard inputs and technology. It is an asset that gives value to the physical capital an enterprise employs, regardless of whether it is profitable or lossmaking.<sup>31</sup> At least this is how Cliff Gaddy and I understood this when we wrote *Russia’s Virtual Economy*. We have recently tried to reconceptualise this asset – relational capital – as a peculiar type of insurance, and I think that this way of thinking about it is insightful.

Relational capital is a legacy of the command economy. In Soviet times, the success of an enterprise director was contingent upon meeting a production quota established by central planners. With high probability, failure to meet the quota (fulfill the plan) exposed the director to risk of penalties. One of the chief sources of uncertainty for directors was possible shortages of supplies of inputs. To protect themselves against supply failures, directors established and maintained good relations with other directors, industrial ministry functionaries, and Communist Party officials at various levels. Relations with Party and ministry officials were important because such individuals could influence the central allocation of inputs. Good relations with other enterprise directors were a way to ensure supplies of inputs ‘horizontally’ (outside the hierarchical allocation system).

Although enterprises varied in productivity, virtually everyone felt the need for such insurance. Success in meeting the quota in one period did not put the enterprise in a better position to meet the quota in the next period, owing to the ratchet effect of Soviet planning: an enterprise that overfulfilled the plan target in one period could expect to have its target raised for the next period. The effect was to equalise the likelihood of plan fulfillment (or failure) for all enterprises. This equalisation, or leveling, implied that the likelihood of missing plan targets was similar for high-and low-productivity enterprises. Thus, the demand for insurance against failure was near-universal.

Today’s scheme of investing in relational capital as insurance is the continuation of the Soviet system, but with some critical changes. Privatisation means that the directors of enterprises have access to the income streams generated by the company’s business.<sup>32</sup> Those streams,

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<sup>31</sup> For the latter, it is the familiar right to appropriate resources for use as inputs to continue production, and thus for managers to appropriate income streams from the enterprise’s continued operations. For the former, it is protection against expropriation of profits.



however, are threatened by the new discipline of the market, under which lossmaking enterprises risk bankruptcy. A key goal of the director, therefore, is to continue production regardless of profitability. For many enterprises, the risk to be insured against is, as before, a shortage of inputs. Now, however, that risk arises not because of failures of central planning but because the enterprise lacks the means to pay for the inputs in the market. Relationships with other enterprise directors and government officials – in many cases the very same individuals as in the Soviet system – are a way to ensure needed supplies.

At the same time, the move to the market has had a differential impact on low- and high-productivity enterprises. While the low-productivity enterprises still need insurance – now because of the likelihood that they will be unable to cover costs – for the high-productivity enterprise, the need for such insurance seems no longer necessary. Hence, such enterprises would prefer to opt out of the insurance scheme that they participated in – building relations with officials – in Soviet times.

The problem for officials is that if high-productivity enterprises opt out of insurance, only lossmaking enterprises remain in the insurance pool. Such adverse selection makes insurance impossible. Without the participation of value producers, the scheme will not work. Hence, officials need to ensure that the participation of high-productivity enterprises continues. This means retaining viability risk for such enterprises. As these enterprises are profitable, this can be accomplished through introduction of expropriation risk.

Relational capital is thus a state-contingent contract with officials. For any level of competitiveness,<sup>33</sup> an enterprise will have profits that are stochastic. In addition to the uncertainty from costs and revenues, however, the enterprise also faces the risk of expropriation. Even a profitable enterprise can be closed down through investigation of the source of its privatization,<sup>34</sup> for example. To insure against losses or expropriation, the enterprise invests in relational capital. The investment is the premium paid on the insurance contract that pays off, either in terms of value enhancement for the lossmaker or postponed expropriation for the profit maker.<sup>35</sup> The fact that a premium is paid for insurance emphasises the point that the protection purchased is

<sup>32</sup> Note that the enterprise does not have to generate a profit for the director to benefit from the income stream.

<sup>33</sup> Gaddy and I have used the concept of market distance,  $d$ , as the state variable that describes how uncompetitive an enterprise is.

<sup>34</sup> The example of Yukos is only too obvious here.

<sup>35</sup> Notice that expropriation is always postponed – there is always the potential for expropriation next period.



temporary and must be continued each period. Notice that in *both* cases the enterprise is purchasing viability protection.

Ambiguous property rights are a critical feature for viability insurance to have a positive price. If property rights were well-defined and secure there would be little need to purchase such protection from the government. Paying legal taxes would suffice. Hence, it is hard to imagine that a monopoly viability insurance provider would willingly allow the rule of law to develop. This would make the provider's product obsolete.

### **MONOPOLY VERSUS COMPETITIVE INSURANCE**

Notice that in the previous regime insurance coverage was supplied by a web of relationships, both formal and informal. Some were at the centre, other with local officials, others still with directors of key enterprises. The purpose of these relationships was to insure plan fulfillment. During the early period of transition, the importance of these relationships persisted. What changed was their purpose; enterprise survival was now the key issue.<sup>36</sup> However, a web of relations was still needed because the risks that an enterprise was subject to were multiple. The enterprise's reliance on good relations with suppliers, consumers, and officials, was enhanced by the uncertainty over the nature of the regime and environment, as well as the lack of liquidity and legality that characterised this period.

This situation changed dramatically in the period after 1998 as a depreciated rouble and then high oil prices invigorated the economy. The nature of the risks that enterprises were subject to narrowed. And the growth in federal revenues made it possible for the state to reassert its authority – to become the monopoly provider of insurance.

Notice that with higher oil prices and a more vibrant economy the insurance function of the state – in particular, with respect to dinosaur enterprises – became less paramount. This created a potential crisis for insurance providers. Economic recovery led profitable enterprises to question whether they should remain in the insurance pool. The state responded by measures to keep them in: increase the expropriation risk.

This brings us back to the Northian conundrum. High oil prices created the circumstances under which the inefficient institutional regime of viability insurance could have eroded with relatively mild costs. Increased export revenues, increased tax compliance, and the remonetisation of the economy indeed led many observers to believe that this was in fact going to occur. Yet,

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<sup>36</sup> See Ickes and Ryterman (1994).



this appears not to have happened. The organisers of viability insurance have adapted to changed circumstances to avoid their own obsolescence. They have done so by increasing the risks of expropriation, and thus generating the demand for their own services. Seen in this light, Putin's attack on Yukos seems almost inevitable. Imagine if Putin had not acted: Yukos and other successful companies cease paying their premiums – they exit the pool. The state becomes less decisive a player, and alternative sources of power develop. A possible avenue of development would have been a shrinking of state power and reliance on taxation alone as a source of state revenue. However, this path presented a fundamental dilemma: as successful enterprises thrived outside the state their power *vis-à-vis* the state would grow. At some point they could capture the state. This might be efficient in terms of economic growth and even welfare, but it would be inimical to state power. How long before control of the state would be determined by some political competition? And how likely would it be that control of financial resources would play a key role in this competition?

There are costs to attacking Yukos, of course, chief among them poorer economic performance. However, to assume that this consideration is decisive stretches the imagination. Putin's maximand is not social welfare but state power.<sup>37</sup> Like all incumbents, Putin seeks to preserve his position and those of his supporters. What makes Putin successful is that his system – viability insurance – brings him the support of those opposed to serious structural change. And, of course, that it is well-adapted to the particular economy.

The system of viability insurance looks like a protection racket, and it is often so described. Seen in isolation that is what it is. What is important, however, is the larger context – insurance against expropriation for the profitable and support for the dinosaurs, in a system that maximises personal support for the leadership. Putin cannot provide support for the dinosaurs unless he can keep the profitable enterprises in the insurance pool.

What Putin has achieved is thus an evolution of an institutional regime – *a la* North. The *viability insurance* scheme has evolved and has become more efficient and adapted to changes. It is a system that has its own logic. This suggests that it will be very difficult to reform on the margins, or by ignoring the systemic aspects. Passing laws that promote tax reform or bankruptcy are

<sup>37</sup> One could also point to the growth in state control over energy resources in Russia. This is inefficient – Yukos, after all was the most efficient producer in Russia, and foreign investment and technology is likely needed for exploiting resources located in inhospitable locations. However, state control over energy provides an instrument of state power that is most powerful; an effective tool for both internal and foreign policy. Control over this instrument may be worth the sacrifice of significant future revenues.



not enough, because the systemic aspects cause the implementation to differ from the intention. Viewed as protection, it would seem that effective laws would be enough to eliminate such practices. However, this ignores how relational capital fits into the Russian political economy. It must be understood and dealt with as a system.

## CONCLUSION

Whether Russia will follow a trajectory that, in the distant future, resembles Argentina in terms of lost opportunity is unknowable at present. Dysfunctional institutions may persist for much longer than we expect but they are not impervious to change. Otherwise, there would be no field of transition economics. Persistence does not imply permanence.

My argument in this essay has been that to understand persistence, we need to understand the environment in which dysfunctional institutions operate. Policies that appear perverse when viewed in isolation are part of a system that has its own logic, though it is a system that is socially destructive. Understanding that logic is the key to figuring out how to reform the system. Thus it is perfect comparative economist territory. And I would claim that studying this perverse system is at least as interesting as studying 'normal' ones, and that we will learn much more for our efforts.

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