

## **Brochure Guide to the Book**

### ***Institutional Constraints on Modern Economic Growth***

*How to import modern Western Institutions to suppress economic growth in underdeveloped countries? Russian experience and some warnings for newcomers reformers*

The monograph *Institutional Constraints on Modern Economic Growth* deals with the most dangerous obstacles standing in the way of long term economic growth. Some of these obstacles have been studied extensively, while others are well known but have been largely forgotten over time; finally, there are some that for various reasons are normally ignored.

The economic discipline considers human behavior through the prism of people's interests and attempts to maximize a certain good under conditions of limited resources. People's interests to a large extent depend on "the rules of the game" in effect in a given country and society, and on the organizations and social structures ranging from family to government, which ensure that these rules are observed. Most countries and peoples live in poverty, remaining for centuries unable to "catch up" with the leaders. In such countries, the true law is not a written text, but the arbitrary will of the ruler or the leader of some armed group. The value of human life for the state and society in such countries is negligible, while losses and victims can be counted by the thousand, or even by the million.

Economists are all in agreement that securely guaranteed rights of private property are a *sine qua non* for long term economic growth. In countries where human life does not constitute a value for the state, the right to private property cannot be guaranteed. That is, in such countries there is no way to ensure the availability of the minimal conditions for economic growth.

The majority of stimuli which contribute to economic growth constitute a system of logically interconnected elements. In the same way, the majority of obstacles standing in the way of long term economic growth have common roots.

The book which we want to introduce to the reader at present is first of all devoted to the problems which arise in any country making attempts to rise up and maintain itself on the way to stable (*sustainable*) long term economic growth.

There are two leading approaches to solving the problems which arise in connection with the relations between society and the individual.

The first approach is based on the assumption of the citizens' limited capacity for concerted action, and the state's having access to the total (or significant) quantity of information. In this case, the citizens are in need of protection from the market and from free

competition. In the modern world, this approach finds its expression in the state's seeking to extend its sphere of responsibility and authority in such a way as to make it encompass not only the "pure public goods," but also the "mixed public goods," and at times even the private goods. At the same time, the state's responsibility to the citizen incapable of concerted action is minimal, while its control of citizens' behavior and the behavior of private organizations reaches maximum possible levels.

By contrast with the first approach, the second presupposes that nobody can solve the individual's problems better than the individual him or herself. Despite the individual's limited access to information, he or she can resolve problems independently, without interference by the state. The individual can also correct his or her own mistakes, provided nothing threatens the individual's life and liberty. The second approach considers the individual to be perfectly capable of concerted rational action, such that nobody can dispose of the individual's property better than the individual himself. Given such an approach, the state's only function is to provide the "pure public goods" (that is, defense, security, and justice).

At the end of the 18<sup>th</sup> century, V. F. Humboldt formulated the objectives of the state, which correspond to these two approaches: "A State, then, has one of two ends in view; it designs either to promote happiness, or simply to prevent evil"<sup>1</sup>

Ever since Adam Smith, economists have been comparing the leading and the backward countries with each other, in an attempt to explain the successes and the fiascoes in their economic development.

For the greater part of humanity and in most countries today, the problem of retarded development is still a real concern. This is why it is crucial to come up with a detailed description of reasonably reliable development venues. Such a description requires a thorough understanding of what must be adopted from other sources and what must be initially available (capital, knowledge, reasonable laws, and so on) in order for the economy to embark on a road of stable growth, and to do so at a rate higher than that in the developed countries.

After two centuries of modern economic growth,<sup>2</sup> a phenomenon now widespread among a considerable, even though still a minority part of the human race, is the widening of the gap between the rich and the poor countries. This gap today exceeds any bounds it had ever known

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<sup>1</sup> Humboldt W. von, *The Sphere and Duties of Government (The Limits of State Action)* [http://oll.libertyfund.org/index.php?option=com\\_staticxt&staticfile=show.php%3Ftitle=589&Itemid=28](http://oll.libertyfund.org/index.php?option=com_staticxt&staticfile=show.php%3Ftitle=589&Itemid=28) Chapter III (1854 ed.) [1792]. In what follows, as we analyze the import of religion and ideology in economic terms, we will specify the religious-ethical roots of these two approaches.

<sup>2</sup> The notion of "modern economic growth" involves economic growth rates which stably exceed the rate of population growth over time. See Kuznets 1966.

before. At the same time, a large part, even if not the majority, of humanity today continues to enjoy the same standard of living<sup>3</sup> it had a thousand years ago: that is, it continues to balance on the edge of survival.

Countries which have reached a medium level of development have problems of their own, as well. Among such countries are Russia and Argentina, two states which, a series of jerks and tugs notwithstanding, are not managing to augment the list of developed countries with their own names or even to continue significantly and at a regular rate to decrease their lagging behind.

Economists today have a unique opportunity to observe and compare former socialist states which, having gotten off to a more or less simultaneous start, have introduced new institutions at home in the hope of ensuring the conditions necessary for embarking on a path of long term economic growth. Such a comparison is interesting because of the variety of the institutions being introduced (from highly competitive democracy in Lithuania to the grandiose regime in Turkmenia; from the “old fashioned” and nearly free market in Estonia to the interference by functionaries and officials in the management of individual ventures or businesses in many countries of the CIS).

A study of the most recent developments in the post-Soviet states, along with a comparative institutional analysis of the economic history of the 19<sup>th</sup> and 20<sup>th</sup> centuries, can help single out the key factors in economic growth. An influx of capital does not on its own guarantee successful “catching up” in development; nor can such catching up be guaranteed by the import of knowledge and technologies. Capital influx and imported knowledge and technologies may turn out to be of little use if there is no borrowing and entrenching of effectively functioning institutions at home.

Are there institutions which make it possible to turn a backward economy into a quickly growing one which can later become a highly developed economy, as well<sup>4</sup>? If there are, then what are these institutions, and what are the conditions necessary for their effective functioning? The answers to the questions posed make it clear that *the most significant institutions are the protection of private property and the inviolability of the individual person (protection from arbitrary arrest and detention)*. This last presumes the availability of a package of the principal “political” rights, such as freedom of speech, freedom of thought and

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<sup>3</sup> \$400-600 in 1990. See Maddison 2001, 2003.

<sup>4</sup> We are here concerned only with those institutions which have long since established a solid reputation for themselves in other countries, not with locally invented constructs.

conscience, and so on. At the same time, the impact of such institutions as legislation concerning entrepreneurship (registration, licensing, bankruptcy), taxes, funds market regulations, and the like, is in fact limited (see Appendix 1).

These conclusions are arrived at on the basis of a comparative and statistical analysis of institutions in various countries of the world over the last 180-200 years,<sup>5</sup> as well as institutions in the post-communist states in the nineties of the 20<sup>th</sup> century.<sup>6</sup>

## **Key Definitions**

The present work relies on a series of concepts which require precise defining. These are first of all the notions of institution, constitution, society of the “Rule of Law,” society of the “Rule of Force,” and modern or contemporary economic growth.

Douglas North defines the notion of “institution” in the following way:

*“Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction.”<sup>7</sup>*

Without going into any ideological or philosophical-theological debates about the origin of laws and legislation, let us note a number of circumstances:

- Institutions founded upon principles of natural law have proven to be more effective than those institutions, which were constructed upon positivistic principles<sup>8</sup>;
- Some rational subjects are of the opinion that certain constraints are given not by humanity, but by a higher Being. This conviction impacts considerably on laws and legislative practices.

Hayek’s notion of the natural selection of institutions also presupposes that human beings are incapable of rationally constructing an economically effective ethical and legal system based exclusively on individual persons’ own and the historical general experience.<sup>9</sup> That is, at least, the entire system of norms cannot be rationally and consciously constructed by the individual or even a group of individuals consciously coordinating their efforts. So as not to go into a

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<sup>5</sup> K. E. Yanovskiy and S. G. Shulgin, “*Instituty, demokratiya i ekonomicheskiy rost: test 180-letnego razvitiya*” (“Institutions, Democracy, and Economic Growth: Testing 180 Years of Development,” Rus.), 2008, as well as see Appendix 1.

<sup>6</sup> Mau, Yanovskiy, Zhavoronkov, et al. 2003.

<sup>7</sup> D.C. North 1990 (“Institutions, Institutional Change and Economic Performance”), p. 3.

<sup>8</sup> “Positivistic” principles, based on an understanding of law as a function of power, could not provide for the stability and guarantees of the rights of market subjects. Both the Anglo-American and the French system of new (that is, beginning with the 17-19<sup>th</sup> centuries) institutions are based on allowing for a super-state, super-authority origin of the basic laws and rights, and on the absence of the right of the state to alter these basic laws or delimit these basic rights.

<sup>9</sup> “*Pagubnaya samonadeyannost*” (“Fatal Self-Assuredness,” Rus.), Moscow, *Novosti*, 1992. See pp. 61-63 for key institutions, and pp. 47-48 for the evolutionary selection of institutions.

discussion of the problem of the primacy of matter or consciousness in the present work, let us introduce a somewhat more general definition of the notion of “institutions”:

**Institutions** are humanly acknowledged constraints which shape human interaction.

Elaborating upon the definition given by D. North, we also take into consideration those institutions which are based on Biblical moral norms. These institutions are the object of general acceptance and acknowledgement, independently of the will of the authorities.

By the “import of institutions” we will mean the conscious copying (even if not necessarily exact copying) of a well known norm, as well as the instruments for its implementation. **Norms** are any dictates or prohibitions against the performance of some action.

**Society of the “Rule of Law”** is a society governed in accord with generally known judicial norms.<sup>10</sup> These norms are based on prioritizing basic individual rights and freedoms over group and state interests. In such a society, requisite safeguards for individual rights and freedoms are securely provided, including the use of force to ensure these rights and freedoms. Such safeguards include the independence of the courts, which is provided for by law and tradition. The courts’ independence finds its expression in that the state, as represented by the highest ranking officials and agencies of the authorities, may in the course of litigation in court lose<sup>11</sup> a suit of some considerable social import against a private individual.<sup>12</sup>

**An institutions package** is the sum total of the norms and offices historically integrated as complex unities and possessing a common ideological grounding. The component elements of an institutions package may be some set of traditions, religion, church organizations, morals, types of family relations, or various legislative constructs. However, there is no way to indicate with any degree of precision which of these elements play a decisive role in determining the eventual successes and failures in the course of the economic development of a society that makes use of a particular package of institutional instruments. But we can analyze the practice of implementing particular institutions packages. Some of them yield positive results and provide a way to embark on a path of long term economic growth, while others do not.

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<sup>10</sup> At the same time, norms may be an unwritten but generally accepted tradition; they may be founded on a precedent court decision; or they may exist as a formally ratified law.

<sup>11</sup> As an example, we may cite the US Supreme Court decision concerning the illegality of the procedure used to reach decisions about arresting terrorists at the Guantanamo military base. The decision caused serious problems for the US administration. See the decision in the case of *Hamden vs. Rumsfeld, 04-70*, decision of June 29, 2006.

<sup>12</sup> Mention of such a process can easily be come by in the archives of the press. Losing in court in case of a labor dispute or dispute concerning property (that is, a dispute concerning small claims) was a real possibility for a government or state office or enterprise even in a totalitarian state, including the USSR. For instance, cases of rehabilitation at work as based on a court decision were even then not outstanding exceptions, even though in situations of this kind the suing party would normally be an individual person, and the defense a state or government agency.

Occasionally, the real integration of institutions packages takes place during elections when a party makes an offer and the voters choose not some one particular institution, but rather an entire package. In developed countries a consensus with regard to basal values prevails. Accordingly, parties discuss the relationship between taxes and social programs (taxes a bit higher and more social programs, or taxes a bit lower and fewer social programs) and the accent marks in the structure of the public goods provided (more defense and security or more state spending on health services and education). Basal institutions, by contrast, do not come within the purview of the discussion. For example, in modern informational society there is no problem of proportional coordinating along the lines of: “the right to life (security) or freedom of speech.” In transit countries no consensus concerning basal norms has as yet been arrived at, so that the institutions packages under discussion may differ from each other in fundamental respects. Some packages may contain a set of institutions typical of a totalitarian state, while others may feature sets of institutions associated with “Rule of Law” societies.

**Free elections** are elections to government office, conducted in the presence of the press from the opposition, and freedom of union. Government agencies are authorized to act in ways which are limited only by the rights of citizens and other private persons, a fact which is, as a rule, established clearly by the constitution. Elections of the sort specified are elections conducted on the basis of a declarative order of the registration of parties, blocks, and candidates; on the basis of the physical security of their campaigning; and on the basis of a transparent totaling of votes, as well as of the absence of any opportunity or precedent of arbitrary denial of right of access to the elections for a party represented in parliament or having a rating which is a priori sufficient for participation in the elections.<sup>13</sup> Freedom of choice necessarily presupposes guarantees of the physical security of the voters, both during the elections and following the announcement of the election results.<sup>14</sup>

**Opposition press** is the press which accuses the head of the executive branch of the government of illegal or immoral action, or else of ineffectiveness which endangers the country or society and of discharging his or her obligations in improper ways. In such a case, the head of the executive branch of the government required to be (should be) replaced on the basis of new elections (recalled from his or her position).

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<sup>13</sup> At the same time, the elections mechanism is of no crucial significance (we presume that, if genuine political competition is assured, all the players in the game will adapt to any legislation concerning elections). We are concerned only with an actually operative mechanism for reaching decisions collectively or for altering the type of regime in power.

<sup>14</sup> For the consequences of the absence of such guarantees, see Yanovskiy, Zhavoronkov, and Zatkovetsky 2007.

In view of the widespread use of terms such as “**transit economy**” and “**country with a transit economy**” in the present work, we want to focus on the issue of what constitutes such a condition of being in “transit.” Per capita GNP is inappropriate as a choice of the main criterion for assessing the condition of the economy in this case. For example, high petroleum prices could make Saudi Arabia a rich country, but clearly not a “developed” one in any complete sense of the word, just as earlier a favorable combination of factors had made Argentina rich, even though this nation was unable to retain its place among the wealthiest countries of the 20<sup>th</sup> century. This is why a country with a transit economy is, first of all, one whose institutions do not provide for an effective functioning of the market economy.

By **contemporary** or **modern growth** we mean economic growth rates stably exceeding the rates of population growth. In earlier times, periods of economic growth led primarily to rapid population increase. In more recent centuries, a typical feature of economic growth has been an inverse proportional relation between population growth rates and the GNP. Such a relation between these indicators is in fact what placed countries and their institutions in the center of researchers’ attention.

A *constitution* is the set of values and norms which have become deeply entrenched and accepted among the overwhelming majority of agents. These norms are implemented or put to use with minimal (close to zero) costs, because they are accepted by the overwhelming majority of agents. An “entrenched set” means that changes in these norms are realized at maximum cost.<sup>15</sup>

*Society of the “Rule of Force”* is one in which authority legitimates itself exclusively by force and readiness to resort to coercion in critical situations. In countries run by order of this sort, laws are displaced by the right of the authorities to use force. Force is, then, the main law in a society of the “Rule of Force” type.

By **basic individual rights and freedoms** we mean: the inviolability of the individual person (the individual’s protection from arbitrary arrest and detention), taken in the most general sense of the term, including not only the right to life, but also the inviolability of the individual person who publicly criticizes the authorities or adheres to a creed of which the authorities do not approve. The term also includes private property, including freedom to determine prices and values and freedom of trade. This set of rights and freedoms coincides perfectly with the set of

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<sup>15</sup> Changes may take decades. Thus Biblical values, which form the basis for the institutions of the US, cannot be subject to change. Changes in the US Constitution, not as a formal legal act, but as a totality of norms, cannot be realized within a time span of average duration, insofar as they call for changes in the “soft infrastructure” (for details, see W. Niskanen, “The Soft Infrastructure of a Market Economy,” *CATO Journal*, Fall 1991, vol. 11, issue 2, p. 233).

“natural rights” as described by John Locke.<sup>16</sup> Society may limit these rights only with the aim of preventing the infliction of damage by some private persons upon others, and only on the basis of extant laws.

*Basal institutions* are the totality of basic individual rights and freedoms, and the norms and law enforcing structures which guarantee their being adhered to.<sup>17</sup> Basal institutions have priority from the point of view of borrowing, construction, entrenching, and protection.

In order to begin to consider the costs of such borrowing, construction, entrenching, and protection, it is imperative to assess the way in which the majority of agents relate to them, as well as this majority’s readiness to follow or to resist new rules. In this connection it is essential for us to consider the following definition.

*Demand for institutions* (latent, or revealed demand for institutions) consists of those steps taken by the population, which promote the creation and establishment of certain sets of institutions (voting for parties which support some certain set of institutions, joining in the activities of these parties, taking part in events which include demanding that certain norms be introduced or abolished, and so on). The value of the demand for institutions may be both positive or negative.

The following two definitions will be necessary for a more complete understanding of the demand for institutions (as expressed in voter behavior). These definitions describe two principal “ideal types” of politicians.

A “*leftist politician*” in the present work is a certain “ideal type” of politician in a judicial democratic state. Such a politician argues for expanding the functions of the state *beyond supplying the pure public goods*. A “leftist politician” considers these new functions (supplying mixed public goods, controlling the behavior of citizens and markets) as the main ones for a modern state. He or she believes that there must be higher taxes for the “rich” than for the “poor,” and that taxation must be progressive. A “leftist politician” also speaks out against lump sum taxes (when the same tax amount is levied from every taxpayer). Working on the assumption of citizens’ limited capacity for concerted action and the assumption of the total awareness of all events by the state, a “leftist politician” believes that citizens are in need of

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<sup>16</sup> See John Locke, “Concerning Civil Government, Second Essay,” [http://www.swan.ac.uk/poli/texts/locke/Article 87](http://www.swan.ac.uk/poli/texts/locke/Article%2087), in Chapter 7, “Of Political or Civil Society”: “87. **Man being born**, as has been proved, **with a title to perfect freedom and an uncontrolled enjoyment of all the rights and privileges of the law of Nature**, equally with any other man, or number of men in the world, hath by nature a power not only to preserve his property- **that is, his life, liberty, and estate...**”

<sup>17</sup> Independent courts (independence of judges, their irremovability, the high costs of their dismissal); the transparency of the activity of the law enforcing agencies of the government.



protection from the market and from free competition. Such a politician is, accordingly, convinced of the utility of state controls, explaining all and any failures encountered by such controls by their incompleteness and failure to be all-encompassing.

In other words, a “leftist politician” treats private property and freedom of contract with suspicion, preferring equality of results to equal opportunities. Such a politician is sure of the state’s ability to perform the task of supplying mixed public goods better than the market and private non-state organizations can.

A “leftist politician” defends imposing limits on:

- freedom of consumer choice (in the guise of “protection for the consumer”);
- freedom of speech, by supporting “public” television and radio broadcasts, as well as by imposing limitations on freedom of statements made to the mass media (introducing such constraints under the rubric of “political correctness”), and so on;
- freedom of conscience (i.e., the state imposes some particular attitude toward any one given faith);
- freedom to bear arms and the right of any human being to self-defense and to the defense of his or her dignity and property.<sup>18</sup>

A “*rightist (conservative) politician*” is the proponent of views and preferences that are the mirror opposite of those of the “leftist politician.” He or she assumes that the only function of the state is to supply pure public goods (that is, the state only performs the function of the “night watchman”). A “rightist politician” speaks up for minimal taxation based on a flat rate, and supports indiscriminating lump sum taxation. He or she supposes that only a free media market provides for freedom of speech, and, accordingly, speaks out against the state’s involvement in any activities in this area.<sup>19</sup> From the point of view of the “rightist politician,” an “exemplary” state does not interfere in private affairs, whether business, community, or family. A “rightist politician” is a supporter of the freedom to bear arms.

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<sup>18</sup> In view of the sum total of these indicators, the conservative press occasionally refers to such a politician as a communist. We should make an explanatory note, however, to point out that a considerable number of such politicians have surfaced since the end of the 1960s. Leftist politicians in democratic countries of the early to the mid-1900s often spoke out against private property and the freedom of enterprise, but rarely rejected all basal institutions wholesale. Such rejection, even if in a mild form, has been typical of leftist politicians of the last four decades.

<sup>19</sup> The rightist politician is against setting up administrative barriers in connection with entry into the market, and against state spending used to support any particular mass media.

That is, a rightist politician does not accept Weber's definition of the state as a subject successfully claiming a "monopoly on legitimate physical force."<sup>20</sup> The principal player in this sense does not amount to being the only one.

Based on the outcomes of his research, Vernon Smith draws the conclusion that the tendency to shift one's burden onto others is not all that widespread, and that the free-rider minority is quite comparable with a different minority, namely, the one which, for a variety of reasons, tends to assume a disproportionately high share of the public expenses. Clearly enough, this outcome can be obtained only based on a sample which does not include such agents as those who are confident of their right to enjoy free public goods. Agents not seeing themselves as payers, less for financial reasons than on "ideological" grounds ("ideological" free riders, pretenders for a free ticket) destroy the picture. Their significant minority (if it has not yet in some countries become the majority) can no longer be balanced out by a small group of wealthy philanthropists.

We devote particular attention to the institutions grounded in the moral norms of **monotheism**. This last presumes the teaching based on what has come to be known as "Sinaitic Revelation." The teaching's sacred texts include a set of much reiterated requirements toward the individual and the state to impose restraints on one's own behavior and wishes in accord with laws given from on High. The teaching also encourages its followers to study its texts, including doing so even by means of independent effort. At the same time, monotheism does not cover those versions of the teaching, which are founded upon a notion of successful violence as ethical or that represent their patron as a Higher Being whose chief expression of favor to his believers is granting them success in violence<sup>21</sup> ("Divine judgment" in the Middle Ages in Europe, cult of the Shahids, and the like).

Generalizing, we can say that a "rightist politician" is a classic liberal of the 17<sup>th</sup> to the late 18<sup>th</sup> centuries, characterized by a neutral or positive attitude toward religion.

By a "closed **democracy**" in this book we mean a political regime which conducts formally competitive elections. At the same time, the majority of the electorate has no chance of changing the authorities' policies by means of voting and while remaining within the framework of the Constitution, because of the constraints imposed on them by the non-elected institutions. Among such non-elected institutions are: the legal system of courts, the law enforcing agencies of the government, the mass media, and the army.

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<sup>20</sup> Weber 1990, p. 645.

<sup>21</sup> The distinctive feature of paganism consists less in the multiplicity of deities than in anthropomorphic notions of the Divine. In the thinking of a pagan, a divine being is subject to the same passions as humans, but experiences them remarkably strongly. The god Odin, who welcomes the mighty and valorous slain fighters to Valhalla in Old Norse mythology, appears more ethically demanding and less "humanlike" in this respect than a formally unique "God" who ushers the murderers of women and children into heaven.

## ***On Reasons for the Wealth of Nations***

A fundamental condition for the inviolability of private property involves guarantees of the inviolability of the individual person (protection from arbitrary arrest and detention). This conclusion is confirmed by the results of a comparative inter-country analysis of institutions over the course of the last two centuries and an analysis of the institutions in countries having a transit economy.<sup>22</sup> Only when not fearing for their lives and unafraid of arbitrary arrest, are economic agents likely to concentrate their efforts on activities of production, to defend their property in times of need, or to insist on their rights and legal interests in different spheres of endeavor, rather than seek opportunities of business emigration.

A sine qua non for the development of private initiative is the condition of the individual citizens' resting assured that their success or prosperity, as manifested by their having houses better than the police officer's, or having cars more expensive than the town mayor's, or having spouses more beautiful than the governor's, will not lead to castigating measures taken against them by any one of these functionaries. If this condition is not fulfilled, any formal guarantees of freedom of private enterprise and protection of private property are not worth the cost of the paper they are printed on.

Accelerated development in countries ruled by authoritarian regimes often turns out to be unstable.<sup>23</sup> By contrast, countries which guarantee authentic inviolability of the individual person not only successfully develop in their own right, but also contribute to the acceleration of economic growth rates in the entire world (by means of information and knowledge, capital, and institutions).

### **Why Stable Systems Turn Out to Be Unstable**

One of the principal questions addressed in the present work is the issue of why the classically liberal system of a compact state, the "night watchman" of the 19<sup>th</sup> century, turned out to be unstable. At the same time, we have no intention of competing with Ludwig von Mises, Friedrich Hayek, Adam Smith, Charles-Louis Montesquieu, Frederic Bastiat, or Richard Cobden in explaining the reasons for the unraveling of socialist and statist systems.

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<sup>22</sup> K. E. Yanovskiy and S. G. Shulgin, "*Instituty, demokratiya i ekonomicheskiy rost: Test 180-letnego razvitiya*" ("Institutions, Democracy, and Economic Growth: Testing 180-year-long Development," Rus.), 2008; see also Appendix 1.

<sup>23</sup> Przeworski et al., 2000; see also Appendix 3 to Chapter 5.

## ***On the Reasons for the Poverty of Nations***

In analyzing particular instances, we will resort to the method of proof by contradiction, or *reductio ad absurdum*. We will consider the outcomes to which the absence of guarantees for the security of the individual person and property leads.

Richard Pipes notes<sup>24</sup> that any despot considers any property and all life to be found on the territory under his control as part of his own property. Institutions functioning on such territory completely preclude safeguards for the security of the individual person or property, thus effectively “preventing” long term economic growth. Such an attitude toward people and property was typical, inter alia, of Hitler: to the question of why he does not socialize property in Germany, he is reputed to have answered that he has already socialized people.

### **The Robbers of Today: Special Interests Groups**

In judicial democracies, there is never a dearth of people who evince a clear tendency to social parasitism. That is, people who consider independent work and wages to be something insufficiently prestigious. Operating within the parameters determined by law, such people attempt to achieve a partial “takeover” of the state so as to derive some benefit of their own from it.

In what follows we will begin to consider the behavior of groups of people who specialize and do their training in forced redistribution “within the framework of the law.” This discussion opens with the survey of works by Mancur Olson, who first introduced and provided a detailed description of the notion of “special interests groups.”

Groups of this sort seek opportunities, including resorting to force, to limit and regulate the market by means of taking over the state; that is, by infiltrating state institutions. The force to which they resort is supposedly rendered legal by elections and modern court procedure. It is important to note that this force is much more considerable than what is available to any team of gangsters or any “roving bandit.”

Special interests groups (the “modern gangs”) have no long term interests. This is precisely what makes them capable rather quickly of bringing entire sectors of the economy into a condition of decline, and of endangering the likelihood of continued economic growth in large developed countries.<sup>25</sup>

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<sup>24</sup> Pipes 2000, based primarily on the example of Russia.

<sup>25</sup> For instance, the coalition of small transport operators, who lobbied – and achieved – regulation controls of the railroads in the 1930-’70s in the US; or car manufacturing trade unions of the 20<sup>th</sup> to the early 21<sup>st</sup> centuries, also in the US. For further detail, see the Chapter on interests groups.

Regrettably, Russia has managed to accouter herself with a considerable number of influential special interests groups, even though she has not yet constructed that many Rule of Law Democracy institutions.

A special interests group stands behind almost every case of extraneous regulating and control or any other form of interference by the state in the life of private citizens (or market agents). The wellbeing of such groups increases at the expense of society as a whole. The greatest of the losses to society consists in the delimitation of opportunities for economic growth.

A challenge along these lines, with the interests of special groups pitted against opportunities for economic growth, is typical not only of societies of the Rule of Law type, but also of the type of the Rule of Force. The difference consists in that in societies of the Rule of Force type, the spectrum of possible ways of influencing the behavior of private persons is significantly wider, including the most diverse forms of coercion. The opportunities of eliminating resources are also correspondingly greater. However, the resources themselves are as a rule fewer in number, since societies of the Rule of Force type are not rich.

Institutions in the Rule of Law type of society put constraints on the activities of politicians and special interests groups which are aimed at channeling administrative revenues their own way. By contrast, societies of the Rule of Force type, where power derives from coercion, there is nothing to limit the activities of the groups of people listed, whose actions are aimed at benefitting themselves to the detriment of economic growth.

## ***The Structure of the Book***

All happy families resemble each other;  
every unhappy family is unhappy in its own way.

L. Tolstoy, *Anna Karenina* (Part I, ch. 1)

Like happy families, states stably prospering in their long term economic development have more in common with each other than they have mutual differences. They all securely stand guard over the private property of every citizen and every company, even if some citizen is personally abhorrent to the president, the prime minister, the governor, the king, or any other “strong man.” The courts and the law in such societies are stronger than the strongest leader in the world. As Adam Smith noted,<sup>26</sup> this is why the legal system in such countries provides the strongest stimulus for the development of all types of economic activity.

At the same time, a multitude of ways has been invented over the millennia of human history for thwarting stable long term economic growth. And the process of inventing new ways of doing this appears to be going on inexorably. “After the fall of communism, everybody in the world agreed that socialism was a failure. Everybody in the world, more or less, agreed that capitalism was a success. The funny thing is that every capitalist country in the world apparently concluded that therefore what the West needed was more socialism,” M. Friedman wondered in 1993.<sup>27</sup>

The first three sections of this book are concerned with the description and analysis of the various possible ways and institutional obstacles which can block economic growth.

*The First Section* studies the problems encountered by backward countries attempting to catch up with the leading states. An especially common problem for such countries (primarily the post-Soviet states) is the lagging behind of institutions which are supposed to furnish and ensure legal order and justice.

The first chapter is devoted to a study of the problem of the lagging behind of institutions, and to suggestions for resolving this on the basis of the experience of old Rule of Law democracies.

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<sup>26</sup> “...but above all, that equal and impartial administration of justice which renders the rights of the meanest British subject respectable to the greatest, and which, by securing to every man the fruits of his own industry, gives the greatest and most effectual encouragement to every sort of industry.” Book 4, Chapter VII “Of Colonies”, Part III “Of the Advantages which Europe has derived from the Discovery of America, and from that of a Passage to the East Indies by the Cape of Good Hope.”

[http://www.richmondfed.org/publications/economic\\_research/the\\_relevance\\_of\\_adam\\_smith/](http://www.richmondfed.org/publications/economic_research/the_relevance_of_adam_smith/)

<sup>27</sup> “The Real Free Lunch: Markets and Private Property,” *Speech Given at the Opening of the Cato Headquarters in Washington, D.C., May 6, 1993.* <http://www.cato.org/speeches/sp-mf050693.html>

The second chapter considers problems of the influence of special interests groups on the mass media and the system of education.

The third chapter studies the activities of special interests groups as a factor obstructing economic growth.

*The Second Section* addresses the issue of the ability of the state to provide pure public goods (defense, security, justice) in situations in which unpredictable foreign factors or influences obtain.

The fourth chapter is devoted to political coercion, the motivation for such coercion (or terror), and the possible strategies for blocking this kind of motivation.

The fifth chapter is concerned with the study of financial market institutions and their connection to economic growth.

The sixth chapter studies situations in which a democratic state becomes economically independent of its electorate and thus loses the motivation for defending it.

The seventh chapter analyzes problems bound up with the adaptation of immigrants. Here there is an emphasis on analyzing the stimuli which lead immigrants to accept, support, or undermine effective institutions in judicial democracies (in Rule of Law type societies).

*The Third Section* deals with certain possible consequences of crises considered in the second section, as well as with the crisis in the institution of the family.

The eighth chapter demonstrates the instability of authoritarian institutions and their limited efficacy in all respects except for short term and intermediate length term political stability.

The ninth chapter studies the impact which new ideologies of the 21<sup>st</sup> century (feminism, multiculturalism, and so on) have had on those institutions, through which the Western world has become wealthy and free.

The tenth chapter analyzes the phenomenon of limited (“closed”) democracy. Such a democracy has a thoroughly weakened political competition system, which leads to the voters’ being able to express dissatisfaction with the regime, but makes it impossible for them to make the regime give up its policies or to change the regime by means of elections. The chapter demonstrates that weakening political competition is bound up with weakening the competition on the media market.

The eleventh chapter studies the crisis in the institution of the family. It demonstrates how crisis in the family undermines the possibility of renewal of the demand for judicial democratic institutions, as well as how the crisis eliminates chances of maintaining trust in the economy.

*The Fourth Section* aims to provide a solid grounding for the recommendations for overcoming crises and for strengthening institutions which enable modern economic growth. These recommendations are meant to prevent new threats to the stability of such institutions.

The twelfth chapter analyzes the role of “non-formal” institutions, with morality first and foremost among them. Historical examples are used to demonstrate the role of morality in maintaining key capitalist institutions.

Chapter thirteen compares institutions in democracies featuring universal suffrage with the institutions of the democracy of the taxpayer.

The summary presents the principal conclusions and the most general recommendations for maintaining institutions which aid economic growth.

*To Chapter 1. The Missing State: Failures of the Judicial System, Dependent and Corrupted Courts, Police, and Special Services*

*Chapter 1* deals with state failures in countries with transit economies and weak democratic traditions when the state is called upon to provide “pure public goods” (defense, security, and justice). In other words, the subject matter of this chapter involves those institutions which create the very possibility of the existence of real, rather than merely nominal, private property. That is, this chapter deals with those safeguards of private property which apply to both the private owner and his or her belongings. Such safeguards make it possible to establish clearly the boundaries of property.

Using GNP statistics beginning with data from 1820, *Appendix 1* undertakes the attempt to evaluate the impact which such safeguards have on economic growth. A state whose power is limited by an independent court does the best job of protecting property owners’ rights.

An independent court presumes the independence of judges, their irremovability, and high costs of their dismissal. Court independence is provided and ensured by laws and traditions, and finds its expression in the fact that the state, as represented by high ranking officials and agencies of the government, can lose in court to a private individual in the course of a litigation of some significance to society as a whole. The availability or absence of independent courts is treated as a logical variable. When independent courts are available, which can guarantee the inviolability of property owners and of private property, long term stability of economic growth rates is assured. If such courts are not available, when the inviolability of property owners and of private property is not guaranteed, economic growth rates often turn out to be much lower than when independent courts are in evidence. This is due to the fact that development occurs in lurches: instances of noticeable acceleration alternate with sharp decreases in growth rates.



Thus, the per capita GNP in Russia over the last two centuries is not even approaching that of the leading countries of the world. The ratio of the GNP in Russia to the same indicator in Great Britain in 1820 was higher than 40% (as based on purchasing power parity; see Table 1). Later, despite all the desperate attempts made and the incredibly high cost of industrialization, the gap did not diminish. The situation is similar for China.

*Table 1*

**Ratio of the GNP of Russia and China to the GNP of the Leading World Countries  
(in %, based on purchasing power parity)**

	<b>1820 (Great Britain)</b>	<b>1900 (USA)</b>	<b>1913 (USA)</b>	<b>2006 (USA)</b>
Russia	40,5	30,2	28,1	22,0
China	35,3	13,3	10,4	19,5

From: Maddison 2009 [http://www.ggd.net/maddison/Historical\\_Statistics/horizontal-file\\_09-2008.xls](http://www.ggd.net/maddison/Historical_Statistics/horizontal-file_09-2008.xls).

The modern understanding of genuine private property includes the assumption of the inviolability of the person of the property owner. Without this, the difference between private property and medieval “conditional tenure” becomes negligible.

The inviolability of the person of the property owner is assured by the state’s supplying three classic “pure public goods”:

- defense (protection of the property owner from aggression from abroad),
- security, and
- justice (protection of the property owner against arbitrary action and coercion within the country).

The creation and maintenance of a combat ready military, uncorrupted law enforcement government agencies, and an independent court system subject only to the law, are duties of primary importance when reforms are under way. These “pure public goods” are extremely important for long term economic growth.

In Russia, the quality of the court system and the law enforcing agencies of the government continues to remain low, despite an entire series of attempts at reform and disparate achievements here and there. In the early 1990s, reformers’ attention was principally focused on economic transformations: their objective was achieving financial stability and privatization. The absence of financial stability posed the imminent threat of social explosion and economic collapse. Privatization was already outfitted with ready-to-use options for implementation, which had been tested by other post-socialist countries.

An understanding of the importance of reforming the court system and law enforcing and judicial government agencies came later (in the late 1990s). Significant and lasting achievements

in the area of creating an atmosphere favorable to the growth of business and the economy turned out to be impossible without such reforms.

*Chapter 1* provides a solid grounding for the choice of a set of institutions, both courts and law enforcement organizations, based on the example of institutions which have been formed in the developed countries. Some of these were first borrowed back at the time of the reforms introduced under Czar Alexander II, and then for decades functioned successfully in Russia.

When introducing reforms of the court system and the law and justice enforcing agencies, it is crucial to be prepared to put down special interests groups which have grown strong over the last fifteen to twenty years. Problems associated with the activities of such groups when reforms are being introduced, are discussed in *Chapters 2* and *3*.

#### *To Chapter 2: The Crooked Mirror*

Can the absence of freedom of speech, a monopolized media market, and a politicized education create obstacles which will stand in the way of economic growth? The answer is an unambiguous Yes, and substantially. Partial, biased, or heteronomous mass media and an education turned into a propaganda channel not only undermine the regeneration of quality human capital, but also weaken the safeguards for the inviolability of the human individual. As has been demonstrated in *Chapter 1*, in the absence of such safeguards, private property cannot be securely protected.

State, “public,” or simply state-controlled mass media are transformed. From mutually competing information sources they turn into instruments for foisting onto the viewer a system of paternalistic views (that is, views characteristic of the ideal “leftist politician”). State schools and politicized teachers’ professional unions, a normal feature of developed countries, relieve teachers of the responsibility for the quality of education. At the same time, however, teachers are required to impose upon their students certain ideological worldviews. It is quite possible that in the future this problem will become a concern for Russia, as well. Following the model provided by aggressive professional unions in large enterprises, their analogs will take shape within the system of education.

The destruction of a competitive media market weakens democratic institutions and principles, something which in turn annuls political competition and the separation of powers. The elimination of political competition and of the separation of powers leads, in turn, to the weakening of safeguards for private property. The consequences of the weakness of such safeguards have been described above and in *Appendix 1*.

Besides, an imperfect media market fails to provide transparent visibility of the activity of either state or private offices or organizations, thus leading to a lower level of mutual trust among market agents. This means a reevaluation with a tendency toward the raising of risks involved in transactions, and thus toward the rejection of a large number of potentially profitable deals. In the last few decades, economic growth rates in countries of the EU have been lagging behind those in the US at least partly as a result of the low quality of the media market, rather than exclusively as a consequence of more complex systems of controls and a heavy tax burden. Research has shown that there is a marked positive correlation between economic growth on the regional level and the existence of free mass media in the region.<sup>28</sup>

The distortion of the function of schools leads, in addition to the effects already described of the blurring of democracy, also to the lowering of the quality of the labor force. Because of the shortage of specialists having the appropriate qualifications and skills, some projects need to be given up. It follows that the costs of the services rendered by such specialists become extremely high as compared with normal conditions. The leading position occupied by the US in science and technology, and in the dynamics and volume of sales of intellectual property may be explained in part by the advantages of the media market in the US.

*To Chapter 3 "Modern Robbers: Special Interests Groups and Economic Growth Slowdown"*

It is far from always the case that the wealth of an individual accrues through his or her own industriousness and talent which lead to the appearance of a financially reliable demand for the individual's goods and services on the free market. A strong and cruel type unburdened by any constraints (of either the legal or the moral kind) can simply take whatever he wants by force. In *Chapter 1* we already stressed that successful conducting of business depends in a key way on the preservation of life, health, and security of property owners. This in turn provides for a favorable atmosphere for business. In the next chapter we will look in more detail at the most dangerous (in view of the special features of modern post-industrial society) of the technologies for the "selection" of the values listed above.

In a state whose government is limited by the law and able to perform such state functions as maintaining law and order, the "roving bandit" of the classic type does not thrive. Exceptions to this can be found in situations when the "roving bandit" is capable of taking over the state by

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<sup>28</sup> V. Mau, K. Yanovskiy, S. Zhavoronkov, et al., "*Politichiskiye i pravovye istochniki investitsionnyh riskov v rossiyskih regionah*" ("Political and Judicial Sources of Investment Risks in the Regions of Russia," Rus., CEPRA, 2002). The study did not include regions with capital city revenues (Moscow, St. Petersburg) or super-high shares of revenues from raw materials (such as the Khanty-Mansiyskiy or Yamalo-Nenetskiy Districts).

force. Even when functions of the law enforcing government agencies are something the state can perform only with difficulty (consider, for instance, California during the years of the Gold Rush), opportunities for a forced redistribution of property are significantly limited.

The psychological studies of how people relate to risk and uncertainty, conducted by Kahneman et al.,<sup>29</sup> show a “disproportionately great” tendency of the overwhelming majority of market agents to invest in protecting their possessions. This means that a representative of the minority tending to take risks must choose: to take advantage of his or her tendency and enterprising initiative to satisfy the needs of the people about him or her, or to attempt to take over their property. The resistance of free market agents will be sufficiently effective, a circumstance provided for by the institutional opportunities of a free person in a free country (to organize the efforts of law enforcing government agencies, to hire the services of a guard company, to acquire weapons, and so on).

However, force can be applied even without “unsheathing the sword” for the purpose of self-enrichment by means of redistribution. The most common way is to use the whole of the state apparatus as a “sword,” and to resort for cover to care for the needy and protection of the vulnerable, the ill-informed, the weak, the sick, or the “unwise” economic agents from all kinds of possible dangers.

This trick works best with such covers as: protection of children and women (see *Chapter 10* for more details), of animals, or of national and other minorities. Other covers work well, too: protecting nature (for instance, from “global warming”), protection from technogenic catastrophes or any other type of activity bound up with the asymmetry of information access. All this is a fruitful field of activity for groups of this sort, considering that the global nature of the issues serves as an excellent cover for ill justified expenditures.

Among those “most in need” of protection are often the rich and the strong; for instance, entrepreneurs who are friendly to the authorities. Bankers often stand out among these last.<sup>30</sup> Beginning as far back as the late 19<sup>th</sup> century, the state began to promise – and later eventually to provide – aid for luckless entrepreneurs, dressing this up under the motto of struggling for the competitiveness of markets against monopolies.<sup>31</sup>

The larger the circle of persons in need of protection because of their “simplicity,” the easier it becomes to justify regulatory interference, the growth of the state apparatus, the increase in state insurance programming, and other budgetary expenses. Interests groups may include not

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<sup>29</sup> Kahneman, Slovic, and Tversky 1982.

<sup>30</sup> Kh. U. De Soto 2008.

<sup>31</sup> Armentano 2006.

only bureaucrats, but also businessmen, journalists, politicians, or civil activists. Large state-run companies of the monopoly kind may also become a special interests group, despite their formal accountability to the state.<sup>32</sup>

The mechanism of the impact upon economic growth achieved by means of special interests groups' expansion, has been described by M. Olson.<sup>33</sup> Let us suppose that there exists an opportunity for redistributing action aimed at "protecting the consumer" (who is limited in his or her ability to act). "Protection" takes place by means of obstacles placed in the way of agents entering the market or by means of controls and regulations. Such an opportunity means the absence of prohibitively high costs of corresponding decisions. Such decisions are a burden for the majority of market agents and afford a gain for a small group. If the group is strongly motivated (if the gain in question is considerable), and the majority is motivated only slightly (the loss caused to each economic agent by the introduction of barrier controls is small), then the small group's motivation may overpower the interests of the majority. The minority is strongly motivated and does not have to shoulder high costs of coordination for action. The majority is weakly motivated and, as a result of its numbers and the absence of direct personal ties, has to bear considerable costs of coordination. If the costs of coordination for the majority of agents exceed the losses incurred by each one alone, no coalition of the majority can form. It follows that the chances increase of reaching a decision which will be to the detriment of the interests of the majority. The success of each special interests group stimulates other such groups to attempt to advance their own projects. The growth and accumulation of such projects (regulatory controls and redistribution of incomes) distort the motivation for striving for success among other economic agents. Usually, among members of such groups one can find relatively weak entrepreneurs and officials interested in extending the spheres of their own empowerment and authority.

Olson notes that this is what takes place in the usual situations. Among factors contributing to the formation of interests groups he lists, for instance, urbanization (basing himself on the example of the US). At the same time, developments which lead to the destruction of state structures and, accordingly, to the weakening of special interests groups associated with them, can at times lower the barriers limiting economic activity. If the collapsed institutions are replaced by other, similar ones which are not inferior to them in quality, the country can raise its economic growth rate considerably. This is true even if the country has just gone through war

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<sup>32</sup> Let us remind ourselves of instances of political activism by the GAZPROM Company during the late 1990s.

<sup>33</sup> Olson 1982; Olson 1994.

and defeat, as long as it has rid itself of the parasitism of special interests groups. This is precisely what Olson uses to explain the success of Germany and Japan after World War II, and the Southern states after the Civil War in the US. Olson and his colleagues define the level of influence of special interests groups indirectly: by means of factors which are favorable or unfavorable to these groups' growth. Then they perform a statistical analysis of the mutual relation between average economic growth rates and factors impacting the development of special interests groups. Statistical dependence turns out to be negative and significant (the better the conditions for growth of special interests groups, the lower the economic growth rate).

*To Chapter 4: New and Old Stimuli for Open Robbery*

Besides those special interests groups which take up redistribution within the country, there are organizations and even entire states which devote themselves to redistributing: taking from wealthy and/or poor countries and putting into their own pocket. By contrast with the internal "bandits," the "external" ones are, according to Olson, the classic "roving bandit" types. They offer no arguments except force<sup>34</sup> or a solidly grounded threat of the use of force to support their demands. Their objective is coercion, but along the way they make demeaning demands and claim not simply the right to levy dues, but something barely short of authority over the wealthiest and the strongest among the modern powers.

Forced redistribution of property using the state apparatus was typical of Russia throughout a long period of its history (as has also been the case for most countries of the world). Certain species and technologies for deriving revenues by means of force (or threatening to resort to force) are universal for all industrialized and more or less wealthy countries today. At the same time, terror (or threats of resorting to it) often is a reason for officials of the blackmailed country to initiate collecting moneys not only for defense purposes, but also for paying for dues to the "roving bandits."

The very possibility of receiving incomes not by means of constructive labor, but by means of coerced redistribution, shapes a system of motivation which blocks the opportunities of long term economic growth.<sup>35</sup> Risks and threats to human life and liberty undermine all safeguards of the inviolability of private property. Without such guarantees, stable long term economic growth is impossible, as nearly all economists confirm.

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<sup>34</sup> The meaning of such force for the robbers is to indicate their own might and to provide for their continued successes: to increase power over the controlled population and to intimidate it.

<sup>35</sup> Mau, Yanovskiy, et al. 2003; Yanovskiy, Zatkovetzky, et al. 2005.

It would appear that overcoming terrorism is easier than dealing with the defenders of the “environment,” “citizen health,” or “production of goods by the homeland” within the country, because, theoretically, terrorists need to be physically destroyed, or else deprived of their freedom. However, terrorism continues to remain a very real threat after decades of struggle. In Chapter 4, we consider the incentives which make political leaders, journalists, generals, and voters in wealthy democratic countries defend their country from danger from abroad, or refuse to come to its defense.

The force (technical) capacities of most old democracies for fighting terrorism are blocked by the efforts of groups interested in paying dues to the “roving bandits,” rather than in fighting terrorism. We see that the responses of all the players – terrorist leaders, political leaders of democratic countries, journalists, military personnel and voters – are quite natural, given the current condition of the institutions. In many countries with young democracies, the absence of reform and the corruption of the military and law enforcing agencies prevent the effective dissolution of terrorist groups.

Such a predicament of the political institutions, which generates the stimuli that make large social groups capitulate in the face of foreign “roving bandits,” is unacceptable. It calls for reform. A moral crisis is a significant component of the crisis which accounts for the modern state’s inability to deliver the “pure public goods.” Among other things, a moral crisis is indicated by the attempt to introduce new norms which treat terrorist leaders as members of a privileged minority which must be protected. Special interests groups and “leftist politicians” make use of and actively contribute to the dissemination of norms of this kind.

In chapters dealing with the link among business atmosphere, ideology, morality, sources of the crisis in which democratic states find themselves, and the institution of universal suffrage, we will return to the issue of the modern state’s inability to provide the pure public goods.

*To Chapter 5: Effectiveness and Quality of the Financial Market Institutions*

M. Olson notes<sup>36</sup> that countries with well protected private property and effective management institutions enjoy some advantages in providing for complex, protracted transactions involving a large number of parties. It is no accident that the financial sector is “disproportionately” highly developed in countries with old institutions which have an established reputation respected by property owners.

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<sup>36</sup> Olson 2000.

Current empirical studies show that countries with more developed institutions enjoy greater stability in the face of external shocks. D. Rodrik demonstrates<sup>37</sup> this effect in his study of the connection between quality of institutions and different countries' successfully overcoming the consequences of the "petroleum shock" of the 1970s. The results of the study indicate that countries with effective institutions and unified societies were considerably better able to withstand the shock and implement effective anti-crisis strategies. And conversely: undeveloped institutions and internal social conflicts made overcoming the economic crisis more difficult.

The "unity of society" can be measured by the very existence and duration of perseverance of a democratic regime.<sup>38</sup> Such a regime, given voter approval for its policies, taxation, and budgetary spending, can count on the loyal support of its voter agents at a time of crisis. Stimulating the taxpaying electorate supports the authorities' ability to balance the budget and to provide for the stability of the national currency. Another important factor impacting inflation is the trust placed by the market in its financial authorities. Inflation in a judicial state governed by the taxpayers is taken, *inter alia*, as an unlawful (not introduced by parliament) tax. (It is not by accident that in the US and Great Britain during periods of taxpayer democracy, periods of inflation coincide with periods of wars, while prices remain stable over the long term).

However, the advantages demonstrated by the developed financial markets have an opposite side to them, as well. The disorganization of the financial market (including the outcomes of state interference) promises dire consequences for the real sector of the economy. These consequences come to pass because of the disappearance of mutual trust among the agents, since a most important function of the financial markets is providing the most generalized and formalized of information about the economy.

At present, it is becoming evident that irresponsible financial policies turn into a dire destabilizing factor which threatens the economy and society as a whole. By irresponsible financial policies we mean policies aimed at monetary discharge disproportionate to the economic situation, or which increase the budget deficit and state and quasi-state<sup>39</sup> debt.

In this connection it should be remembered that the crisis of the Roman Empire, which began in the 3<sup>rd</sup> century C.E. and eventually led to the unraveling of the Empire, coincided with a mass corruption of coinage by the state. This entailed the degradation of other institutions, as well (citizenship, professional army, entrepreneurship, and so on).

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<sup>37</sup> Rodrik 1999.

<sup>38</sup> According to the criterion suggested in Przeworski et al., 2000. See Chapter 1 and Appendix 1.

<sup>39</sup> I.e., the debt incurred by state companies.



The process of restoring trust in the state and institutions of the financial market which have been deformed by state interference, is a complex and protracted one. The general growth of distrust and, correspondingly, of transactional costs for all deals can continue to leave its mark over the long term after the initial “collapse.”

*To Chapter 6: Rental Incomes: The of Resource Curse and the Corruption of the Electorate*

If the authorities have the opportunity to receive incomes uncontrolled by society, this gives them great freedom of action. Such incomes do not depend on the quality of the public goods delivered, nor on the investment climate. Given a certain minimal level of organization, taxpayers can try to impose on the government, which needs their money, their own terms for using the resources received (and history has shown that this can often be done successfully). The history of many modern parliaments began with gatherings convened by the people whose money and armed forces made up the might of the state.<sup>40</sup>

The absence of a need for the regime in power to ask its subjects for financial support in return for guarantees and privileges makes the regime’s forces, which are far superior in comparison with any individual market agent’s capacity, practically uncompensated for in any way.<sup>41</sup> And if the government’s incomes enable it to offer bribes to citizens, then the authorities’ uncontrollability can weaken or even destroy the democratic institutions already in existence. Under such conditions, there can be no talk of constraints capable of providing universal secure guarantees for business independently of the will of the ruler.

In periods of resource plenty, the country headed by a generous ruler may appear a thoroughly attractive place. This holds until the moment when the resources run out, leaving behind ruined institutions and weakened habits of self-rule and market entrepreneurship.

In certain isolated cases, the ruler, a “stationary bandit” with good intentions and a well developed common sense, can provide and maintain personal safeguards. But Olson’s presupposition<sup>42</sup> that such safeguards are not particularly secure finds its confirmation in numerous instances taken from history.

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<sup>40</sup> That is, the state’s ability to provide the public good of “defense.”

<sup>41</sup> If only the citizens do not have a comparable military force at their disposal – an unlikely possibility.

<sup>42</sup> Olson 2000.

*To Chapter 7: Immigration: Conditions for Choosing an Adaptation Strategy and Strategies for Avoiding Adaptation*

Modern approaches to immigration policies in most developed countries make the problems of adaptation for new arrivals more severe. Protracted failure to adapt among immigrants (and even of their descendants) turns into recurrent problems vis-à-vis the law, and even extends into large scale incidents. With time, immigrant failure to adapt intensifies, while its localization in space extends to increasingly larger areas.

Motivation for maintaining non-selective and non-working immigration are available in plenty for many bureaucrats and “leftist politicians.” In conditions of immigration of this kind, many of the immigrants become recipients of state aid, turning into a manipulated electorate. In essence, we are here talking about importing manipulated electorates from countries which lack democratic traditions.

Immigration alone does not pose an insoluble problem, provided the immigrants accept the culture – primarily the judicial culture – and the customs of the land where they have arrived. Immigrants either assimilate or else, in cases of culture proximity (e.g., immigration into the US from European countries of the 19<sup>th</sup> to the early 20<sup>th</sup> centuries), they adapt their cultural and legal “baggage” to their new surroundings.

The modern example of Canada and Australia demonstrates that the mechanism of selective immigration allows for an optimal combination of satisfying labor market needs with moderate costs of adaptation for the new citizens. This means that the costs are moderate for all: for the new immigrants, for their neighbors, and for society as a whole.

As a result, in Canada, immigrants’ interests quickly become indistinguishable from the interests of the local inhabitants. This is borne out by voting statistics. The situation is closely bound up with a policy of property qualification. A key moment of the policy consists in that naturalization of aliens depends on their buying real estate in Canada. That is, immigrants must be able not only to earn, but also be in a position to lose something, depending on the course events in the country take.

By contrast, if local citizens are treated as second-class people, the same situation arises as what can be observed most often in the large cities of Western Europe. Where immigrants are too “proud” of their own culture and religion, while local citizens must finance them, the quality of such a public good as “legal order” is detracted from. The quality of such a good, as delivered to taxpaying citizens, goes down, while the costs of delivery increase. Insofar as the quality of poorly adapted immigrants as workers is doubtful, they improve the conditions of the labor

market much less than is normally believed. But, at the same time, it turns out that they raise the social obligations of the state and burden the local working population. The local population then tends to sell housing which has gone down in value, and to move out to those neighborhoods where there are fewer immigrants, or even to immigrate to other countries. These negative tendencies combine with a low birth rate which is bound up with the crisis in the institution of the family (to be discussed in *Chapter 11*). Together, they lead to the crash of state-redistribution systems and to increased tension in private savings pension programs.

The accumulating problems connected to providing legal order, tension on the labor market, and population aging endanger economic growth in most urbanized industrial countries, including both old democracies and post-socialist countries with transit economies.

*To Chapter 8: Authoritarianism and the Cutting-Edge Chinese Experience: Unreliability of “Stationary Bandit” Safeguards Based on the Example of Modern China*

Many people find the economic growth of modern China impressive. This country is gestured toward as a model for imitation by economists with diametrically opposed views: from the libertarians (Cato Institute,<sup>43</sup> A. Illarionov<sup>44</sup>), to the statist (V. Popov<sup>45</sup>). Such unanimity underscores the impression which, if looked into, may turn out to be deceptive.

In this chapter the authors have tried to show that:

- Chinese economic growth is less stable than may appear to be the case;
- the country’s authorities, especially in recent years, have been performing actions which undermine growth stability;
- beginning in the 1980s, the case of Chinese growth features much less that is new and instructive, than is normally believed;
- schemes of rapid economic growth for the long term future, in which China will be able securely to occupy the position of one of the largest world economies, are indeed conceivable, but not very likely to come true.

The phenomenon of rapid economic growth with an enormous influx of foreign investment and furious growth of the export-oriented sector is to be explained by these key factors:

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<sup>43</sup> *Cato Institute* ([www.cato.org](http://www.cato.org)) is quite optimistically minded as regards the likelihood of the continued economic miracle in China, the growth of Chinese potential, and the significance of the country as a partner. (<http://www.freetrade.org/issues/china.html>).

<sup>44</sup> [http://www.libertarium.ru/1\\_ptchina\\_china](http://www.libertarium.ru/1_ptchina_china)

<sup>45</sup> V. Popov, “*Pekinskiy contzensus*” (“The Peking Consensus,” Rus.), *Kommersant* №162 (№ 3493), September 1, 2006; idem., “*Shok i rynok*” (“The Shock and the Market,” Rus.), *Kommersant* № 160 (№ 3491), August 30, 2006.

1. the availability of a cheap labor force in the country where up until the present the process of urbanization has been at its height (slightly above 40% of the population live in cities or towns). Even today, the per capita GNP in China is approximately half of the per capita GNP in Russia, and considerably lower than the per capita GNP in the US.
2. The option of relying on the most enterprising and hardworking immigrants, considering the lifting of bans which had earlier been in effect on mutually profitable deals. (These were first legalized only in the 1970-'80s).

Something that played a key role for China was the end of mass repressions in connection with the legalization of business and the creation of individual informal safeguards (“roofs,” in Russian parlance) for native and foreign entrepreneurs. That is, entrepreneurs did not lose freedom or property at the whim of the authorities enjoying power unlimited by any internal or external force. Changes in the political situation along with the accumulated reserve of financial security created the temptation of increasing control over the economy by means of giving up first guarantees for native businesses at home, and then for those from abroad. This is precisely what is taking place at present, after entrepreneur arrests began, of not only Chinese citizens, but also of non-residents.

A host of prohibitions of the kind that were rife in the pre-reform period (i.e., prior to the de facto legalization of entrepreneurship) are no longer in effect. The best quality labor force has been “pumped out” (or is still in the process of being “pumped out” of the rural areas at present), but no due reproduction of it is taking place in the cities because of the demographic policies of the authorities. At the same time, in rural areas, where the pressure exerted by the governmental demographic policies is relatively weak, population growth rates are higher, a circumstance that lowers the share of the quality labor force on the market.

The likelihood is small that a stop will be put to this tendency, so that high economic growth rates can be stabilized on a sound institutional basis. The accumulated financial reserves do not allow, and will not allow in the intermediate-length term future, for an understanding of the mistakes shaping such a policy. For the moment, the available reserves permit replacing effective private investment with investment of the government type (or investment which is formally private, but undertaken under pressure from the authorities). This “padding” is what obscures the real complexity of the situation from the authorities’ view. The result, in turn, makes it most probable that further unraveling of safeguards for the private sector will follow, along with an increase in state loads weighing down the economy, and so on.

*To Chapter 9: Modern Anti-Capitalist Ideologies*

Ideology is an effective means of coordinating collective action. Even in the absence of laws, it permits functionaries, civil society activists, and politicians to interact in effective ways, advancing and defending their interests. A widespread ideology lowers the costs of taking in a viewpoint which is based on the ideology. A dominant ideology sharply raises the costs of disseminating alternative points of view; in addition, the costs of coordinating action by persons not in agreement with the dominant ideology also go up. This is why dominance of a single ideology creates a situation in which no freedom of speech or unions obtains.

Due to such ideological domination, a weakening of political competition takes place. This, in turn, impacts private property guarantees, and, in the final analysis, leaves certain marks on the business climate.

Religion intertwines with ideology, and so it also has a substantial impact on the behavior of market agents and their ability to cooperate. Ideology and religion influence the choice of profession and type of activity in life, the prestige and respect for property, and thus the quality makeup of the entrepreneur population. Ideology and religion also impact the trust level among transaction parties, and so have an influence on the level of transaction costs.

Barro has shown<sup>46</sup> that the religious factor is closely bound up with the political institutions already in place in a society. Our conclusions demonstrate the same thing.<sup>47</sup> Apparently, the joint impact of ideologies and religions which have a negative approach to individual success and no way of defending or maintaining the institution of private property, correlates in a negative and significant way with long term economic growth rates.

Analyzing modern anti-capitalist doctrines, from today's varieties of statism (etatism) to Islamic fundamentalism, becomes particularly pertinent in this connection.

*To Chapter 10: Closed Democracies*

“Perfecting” democratic mechanisms used to reach decisions concerning the public goods, but doing this at the taxpayers’ expense, can lead to the same thing as authoritarianism. It is also true that a tradition of limiting democracy is no less difficult to correct than a tradition of authoritarianism of long standing.

The source of such “perfecting procedures” may be found in natural resource royalties (see *Chapter 6* above), regular foreign economic aid, or the monopolization of the mass media, the

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<sup>46</sup> Barro 1999a, 1999b.

<sup>47</sup> Yanovski and Shulgin 2008.

court system, and the law enforcing government agencies by a single coalition of political forces and interests groups.

There is a series of countries in which the dominance of one party during certain historical periods seemed quite obvious: Japan (1955-1993, but in fact, after a brief break, until 2009), Mexico (1929-2000), Italy (1947-1993), Sweden (1932-1976, as well as 20 out of the 23 years between 1982-2005), Israel (1948-1977), India (until 1977, 1980-1989, 1991-1998, i.e., for practically 46 out of 50 years the country was ruled by a single group), Botswana, and others.

Tendencies of placing constraints on competition in the mass media by means of taxpayer financing of propaganda in favor of the position of very certain groups and coalitions (“leftist” ones, as we have defined our terms) are international. Today they have spread throughout most democratic countries of the world. This is a situation in which words about “protecting” the competition may imply eliminating it (as, for example, in Israel, where campaigns against alternative or non-public mass media are constructed on the basis of intimidating the consumer. This is done by monopolizing broadcasting services or the press by means of private capital).

The results of action taken along these lines are similar to what has been described above in *Chapters 1 and 2*:

- Weakening of political and media competition;
- As a consequence of the above, weakening of guarantees for property rights;
- Lowering of the transparency of the state, its responsibility and accountability to the electorate and to the taxpayers;
- Increase in opportunities for deriving revenues for interests groups, and limiting of opportunities (increase in costs) for coordination of steps to be taken by the population so as to protect their own rights and legal interests.

*To Chapter 11: Crisis of the Institution of the Family: Causes of the Illness and Its Remedies*

The present *Chapter* studies the attempts made to repeat the statist experiment, which failed in economics, within the setting of family relations. The experiment is grounded in allowing for a special degree of being informed and scrupulous conscientiousness by the state. It also presupposes being sure of the right of the state to interfere in family affairs, a right which takes precedence over parents’ rights in cases of conflict between the state and the family.

Assuming such an approach, the state provides excess control over family relations, a circumstance which distorts the personal responsibility of parents. Then motivation for creating a stable family union and for having children is undermined.

We are concerned with the crisis of the institution of the family, which originates with stimuli artificially generated by new state institutions for spouses, parents, and children. The outcome is the weakening of family ties and a fall in the birth rate, which lead to a series of socio-economic and politico-economic consequences; for instance, the weakening of institutions which maintain and protect property rights and legal order. The fall in the birth rate, primarily among the middle class, brings about tension on the labor market, and makes the problem of financing the non-working population more acute.

The impact of the crisis in the family on economic growth intertwines with the importing of a manipulated electorate (the modern immigration mechanism, supported by “leftist politicians,” as discussed in *Chapter 7*). Together they lead to a blurring of an important element of the human capital, namely, the one which provides for the market agents’ ability to cooperate with each other as part of agreements, of political and economic competition, or of political quid-pro-quo tradeoffs.

The family is an institution which provides for natural socialization of the new generation, including the transmission of the most fundamental norms of human co-existence and ways of defending these norms in the most “economical” and the least coercive ways possible. *Chapter 12* deals with problems arising in connection with the weakness of these norms, and with the blurring of morals.

Putting an end to policies “in the child best interests” is a must not only for economic, demographic, or political reasons, but especially for moral ones. State instigating of marriage partners against each other, of children against parents, of neighbors so as to turn them into informers against each other – all this is absolutely intolerable. Such policies would be intolerable even if they did not blur the very foundations of the institutions which foster people’s trust and reliance on each other in society.

And, true enough, appealing to ethics, uprightness, and morality is a typical instrument in the hands of “leftist” politicians and bureaucrats.

*To Chapter 12: “Old Testament” Morality and the “Traditional” Family*

In this *Chapter* we consider questions of morality as a factor impacting trust in society, as an important element of the “soft” infrastructure (which is in reality much more stable than “formal legislation”), or milieu in which formal legal systems operate. That is, morality primarily will be considered as the institution of institutions. Morality is the institution which, if it is maintained in an appropriate condition, is capable of significantly raising the efficacy level of the

basal institutions, including the institution of private property. Morality is often gestured toward in political and research discussions, for instance, for purposes of eliminating or establishing artificial borders and constraints upon freedom of discussion. This is why moral issues will be approached in connection with the grounding given for such constraints in research contexts, as well as in connection with issues of public choice.

The mechanism of the impact of morality upon economic growth resembles the mechanism by means of which ideology and religion impact economic growth. The effect of such impacting is difficult to measure. As the foundation of the “soft” infrastructure, morality raises the level of trust among market agents, both among those directly acquainted with each other and among those who have never met each other before but hold the same moral views in common. Besides, morality lowers the costs of constructing and implementation of formal institutions which protect private property, as well as institutions friendly to the market. The entrenchment of such institutions leads to the lowering of transaction costs for nearly any deal, and drastically raises the number of potentially profitable contracts. Quality estimates are possible on the basis of a large sample of countries and over extended periods of time (of at least a few generations). At the same time, indications of the entrenchment of morality can be described (or evaluated) as logical variables (presence or absence of a norm). For instance, the state’s having the authority to resolve family conflicts “in the interests of the child,” is described as the presence of the corresponding social service. Moral norms can be evaluated indirectly by statistical means, as well: based on the number of divorces, on the birth rate, on charity statistics and volunteer work (or even on the fact of the availability of such statistics).

The state’s pushing out the institution of the family and societal morality is largely bound up with the common mechanism for transferring individual responsibility to society, and the responsibility of society to the state. The state is interested in maximum resource use and maximal control. Bringing state controls to a maximum possible level runs counter to the existence of any limitations, among which morality is the most powerful and most stable one. The foundation of the “liberation” of the individual from responsibility and from morality hails from the stimuli spawned by the institution of universal suffrage.

Strengthening universal moral standards paves the way for a return to a taxpayer’s democracy, in which the interests of different groups of responsible and cooperatively motivated voters are brought into mutual harmony and synchronization.



In places where the principle of universal suffrage remains meaningful (that is, in democratic countries), it generates a multitude of motives for uncooperative (“opportunistic”) behavior.

The voter bureaucrat is locked into a situation of a conflict of interests: as a conscientious citizen, he or she should support optimal expenditure levels for providing certain public goods, but as a person whose wellbeing and career depend on the volume of expenditures for providing public goods, he or she is interested in supporting volumes and prices which obviously exceed the levels acceptable for most citizens of the state. The bureaucrat is also interested in obtaining excess control and regulatory empowerment and authorization. It follows that a conscientious and enlightened functionary should submit a statement about a conflict of interests, and abstain from voting until retirement or demotion.

A large and growing group of voters is made up of “professional” recipients of aid. Among these, there is an increasing number of persons who have never had any independent income earned by providing goods or services. A considerable group of voters is also made up of immigrants who have arrived with the specific aim of obtaining such aid. It follows that persons, whose interests include the redistribution of resources of the taxpayers in their own favor, also have no moral right to make decisions by voting during elections.

This applies in part also to those entrepreneurs who derive most of their income from the budget.

It also applies to workers of the mass media and the system of education, who are interested in secure financing independently of the quality of the work performed. They demand budgetary financing for themselves (or else defend such financing). However, they are perfectly entitled to defending their positions publicly, but their right to foist their views on budget donors by means of voting is rather doubtful.

The sum total of the agents we have described (albeit this list is incomplete) tends “for the sake of the public good” by force to make the donor taxpayers cover the expenses of their living without suffering from want.

Let us remember the universal and eternally pertinent recipe for flourishing as spelled out by Adam Smith: not overly burdensome taxes and wise laws. Based on this, we attest to the fact that universal suffrage makes society progress toward a condition in which the level of taxation is a priori higher than the optimal. In addition, it is also higher than the level at which mixed public goods are being supplied in society. Consequently, the economic growth rate decelerates.

This thesis can be grounded in a survey of the dependence of economic growth rates on taxation levels.

Another grounding factor is the historical statistics of state budget balancing (the dynamics of state debt) and inflation (see *Appendix 4: The History of Inflation and Budgetary Deficit after the Introduction of Universal Suffrage*). In the age before universal suffrage, problems of financing were almost always an outcome of military cataclysms or other external shocks of a similar magnitude. In the age of universal suffrage, budgetary deficit, growing state debt, and inflation have become the norm.

### **Summary and Conclusions**

We can envision a more rigid system of constraints upon activities of the state, which would be corroborated by the Constitution and would be accompanied by direct bans on:

- Providing most mixed public goods;
- Budgetary deficit and inflation as an illegal tax;
- Interference in the economy;
- Interference in family affairs as based on the assumption of state officials' omniscience concerning the true wellbeing of children;
- Any independent activity (as a participant) on the media market, including a ban on forcing a party in any way to finance another's opinion;
- The restoration of control over the legislative and executive branches of the government to voter taxpayers.

The gradual restoration of weakened institutions of the family and morality and a series of other prohibitions and constraints upon the state, as discussed in this book, can mitigate the urgency of an entire series of chronic problems in modern market democracies. First of all, problems such as:

- Identity crisis and blurring of the foundations of democratic constitutions;
- Weakening and destabilization of the entire financial system (threat of uncontrollable growth of budget deficits and inflation);
- Aging of the population and pension systems crisis;
- Weakening of the guarantees of private property and worsening of the business climate.

Putting an end to the practices discussed in this book will also help restore the attracting capacity of the ideal of judicial market democracies. Judicial market democracies will have a

chance to restore their capacity to attract people seeking freedom and justice (such as equality before the law), rather than seekers of aid.

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