Failures of the State: Theory and Policy[1]

by

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ABSTRACT

The article deals with the evolution of approaches in modern economic theory to the problem of “failures of the state”. This approach, which has developed in opposition to concepts of “market failure”, can be seen as a search for a new strategy of political and economic analysis of mechanisms of resource allocation and of historical social institutions and their effect on the efficiency of economic processes. Special attention is paid to the problem of information retrieval as a starting point for the analysis of the economic functions of the public sector, to ways of funding state undertakings, to the impact of rent-seeking behavior, to the role of the political process, and to negative externalities such as lack of coordination and the presence of the state in the economy in general. An interdisciplinary approach to “failures of the state” takes into account the influence of legal norms and institutions on the nature of allocation of public resources, as illustrated by the examples from the modern Russian economy.

Keywords: failures of the state, public policy, public choice, allocational efficiency, information, privatization.

JEL: B20, D02, D60, K40, L30, P20.

What is the state? For some it is the Fatherland, for some – the law, for others - the Treasury and for still others, the overwhelming majority – it is the Government.

M.E. Saltykov-Shchedrin, *Well-intentioned speeches* (1872-1876)

A strategy ill-prepared is a cause for woe

Miyamoto Musashi, *A Book of Five Rings* (1645)

Calls for the activity of the state in economic life to be restricted date back to the very beginnings of the market economy. For François Quesnay, a leading representative of the Physiocratic school, one of the most important tasks of the state was, actually, to create conditions for "free and unrestricted competition" (Quesnay, 1774, 1960 ed., p.524). The economists of the classical school, for their part, devoted much of their work to denouncing the vast unproductive expenditures of the feudal monarchies.

The classical school introduced a different understanding of the economic functions of the state in a market economy. Alfred Marshall developed the notion of "external effects" ("externalities") and showed that these could impact upon the functioning of the market. Arthur Cecil Pigou, a pupil and disciple of Marshal, demonstrated that the divergence that arose, as a consequence of these effects, between the private and social marginal product prevents "normal economic processes" from delivering the maximum possible growth of national income (Pigou, 1932. p.173). These ideas served as the foundation of the well known theory of "market failures" which led many economists to argue that it should be the function of the state to regulate the failures of the market.

Of course, the actual spread of the economic functions of the state during the last century was due not only to the application of these theories. The social upheavals brought about by the two World Wars and the intervening Great Depression also played their part. But even after the Second World War (and reductions in military expenditure), there was a marked tendency for the role of the state in the economies of the industrially developed countries to expand. This was particularly true of the economies of the former colonial powers. This trend continued for three decades, from the 1950s to the 1970s.

Economists of the liberal ("neo-liberal", "neo-conservative") camp have argued against "excessive interference" of the state in economic life. Friedrich Hayek, one of the founders of contemporary liberalism, viewed the growth of state entrepreneurship and of centralized regulation as an infringement of the fundamental rights of the citizen in that it restricted the freedom to participate in market relations. Defending the idea of competition as a creative process, he quite correctly, in our opinion, wrote of the impossibility of calculating costs with any degree of accuracy, in circumstances where restrictions that were placed on economic freedoms. By contrast with the direct results of interference in the market system, which in most cases are fairly obvious, the indirect and remote consequences for the most part remain unknown…We have no way of knowing all of the costs that can be incurred as a consequence of this kind of interference. (Hayek, 2006, p.75).

The proliferation of negative consequences of state intervention inspired economists to advance, in parallel to the concept of "market failure", the concept of "failures of the state". In 1979 Charles J. Wolf put forward the theory of "non-market failure" and went on to develop this theory in his book *Markets or Governments: Choosing between Imperfect Alternatives* (Wolf, 1979; 1988). Later, the term "failures of the state" acquired currency. Thus, in 1990 Anne Kruger put forward the following hypothesis: In certain circumstances a policy – that in other circumstances might seem desirable for the solution of certain non-economic tasks or even as a means of correcting the "failures of the market" – can give rise to a situation which is even worse than that which obtained before the policy was implemented (Krueger, 1990. p. 18). Theorists in the field of public choice studies increasingly pointed to instances of the "failure of the state" (see Tullock et al., 2002).

Gradually various versions of the theory of "failures of the state" gained equal status to thories of "market failure". As Barry Bozeman has written, the "state failures" models (he uses the term "public-value failure") in their approaches and methods are completely analogous to the theories of "market failure. The analytical strengths and weaknesses of these models in many resects coincide with the strengths and weaknesses of the models of "public-value failure (Barry Bozeman, 2002, p. 157). A popular research work of the Brookings Institute was given the significant title *Government failure versus market failure* (Clifford Winston, 2006). Furthermore, many economists who once justified a policy of state intervention by references to "market failures" are now adopting a more cautious position, acknowledging that the disadvantages associated with "failures of the state" can be even more serious than those resulting from "market failure".

At the beginning of the 1970s, Kenneth Arrow noted that an understanding of "market failures" was a prolonged historical process that cannot yet be considered complete (Arrow, 1971. p. 42). To an even greater degree this must apply to the research that underpins the conception of "failures of the state". However with the advent of the "new conservative wave" the number of theoretical and empirical research studies into the multifarious negative consequences of "excessive" state intervention has increased. In Russia, until quite recently specialists have been very reluctant to make any critical analysis of the informational problems and systematic impact of the activity of state institutions.

In one of his earliest works, Friedrich von Wieser (1876) examined a theoretical model in which the state with the help of non-market methods could contribute to the formation of efficient economic equilibrium (see F. von Wieser, 1929). The idea of a maximization of a particular aggregate function that reflected social preference was more or less clearly formulated as early as the "marginalist revolution". About one hundred years later Gordon Tullock reconsidered this approach. He suggested comparing the theoretical model according to which the state maximizes social welfare, with a model of maximization of profit by private entrepreneurs (Tullock, 1978). He concluded that maximization by private entrepreneurs can be estimated much more accurately and that this calculation lends itself more readily to meaningful interpretation.

The theoretical model of the behaviour of the state encounters many difficulties associated with the need to provide a quantitative definition of "social welfare" and with the extent to which it is possible to acquire basic evidence on the preferences of individual participants. Using theoretical models, Leonid Hurwicz has convincingly shown that models of the functioning of decentralized market mechanisms are much less dependent on the availability of basic evidence (Hurwicz, 1986). However, market mechanisms by their very nature are incapable of delivering many public services. This means that the following questions have to be faced: which mechanisms of maximization (by the state) of social welfare can be employed and can the operation of these mechanisms be effectively regulated?

The importance of information

When it comes to the setting of goals and deciding upon the course of economic policy (in the broadest sense of the term) a wide range of information is needed and analysis of the economic functions of the public sector must start with be the problem of gathering and processing this data. The problems that arise differ qualitatively from those associated with the normal functioning of private enterprise. Contemporary economic analysis of the functioning of market mechanisms suggests that the real preferences of individual participants become apparent in the process of interaction of competitive forces and that the accumulation of all necessary information is inseparable from transactions for the purchase and sale of goods and the hiring of real assets.

When state enterprises undertake any more or less standard market operations, their behaviour is, as a rule, less flexible and when the state delivers services that the market cannot deliver (for example, social services) information concerning the preferences of participants is completely absent. The author of the concept "revealed preferences", Paul Samuelson, noted that it is difficult (if not impossible) to devise mechanisms that will reveal preferences as to choices between social goods (Samuelson, 1954). Much of what he says is relevant to the redistributive policy of the state, including the distribution of private goods.

William Vickrey and other economists have designed game theoretic tools aimed at identifying preferences for social goods (Vickrey, 1961 etc.). It is rule of the game that the resources contributed by a player are spent exclusively on social good preferred by that player. Players may not answer simply "yes" or "no"; command of a significant amount of information is needed; and the calculations that have to be made are fairly complicated. For example, a player must make his or her own cash evaluation of the benefit that he or she will derive from the provision of a particular social service. As Dennis C. Mueller has noted, the information that is needed by participants in this kind of decision-making is much more complex than that which is needed to participate in the kind of voting systems that are currently in use. (Mueller, 2007, p. 235).

The elaboration of new methods for identifying preferences for social services has led to the appearance of a special branch of micro-economic theory – "mechanism design".[2] Some of these theories deal with more general issues such as resource allocation. Analytical constructs of this kind have produced, for example, new theories of auctions but as before the question of how far these "intellectual experiments" have any practical application remains open.

When preferences are expressed at the level of the individual, the problem of aggregation cannot be avoided. Even if there existed more realistic ways of identifying the preferences of individual participants for the satisfaction of their "non-market" needs, the state would inevitably encounter serious problems in relating the preferences of individuals for particular utilities to collective choice. This is the problem of obtaining a ranking of preferences that would make possible the construction of a social choice function defined by the preferences (choices) of the majority of participants. According to the "impossibility theorem" of Arrow (1963) and of Gibbard-Satterthwaite (1973 and 1975 respectively), if conditions for the expression

[2] A substantive review of the theoretical work in this field is to be found in Palfrey (2002). The article of Michael Rothkopf, *'Thirteen reasons why the Vickrey-Clarke-Groves process is not practical'* (Rothkopf, 2007) marked a new stage in the discussion of the practical application of "mechanism design".

of individual preferences are consistently applied, then voting will produce agreed preferences only under a “dictatorial” voting rule.

The following circumstance is particularly important: existing methods for identifying individual “non-market” preferences are of no help in creating mechanisms for improvement in allocation efficiency. As Nicolaus Tideman has written, if participants in the economic process expressed their preferences truthfully, this would provide information need for the realization of Pareto optimality; but any suspicion that the information in question would be used to achieve Pareto optimality…would motivate people to provide incorrect information (Tideman, 1997. pp. 237—238).

This means that many difficulties arise in the gathering and utilization of data relating to the preferences of participants, whether the evidence relates to the principles upon which state activity should be based, or to procedures for determining what is “social choice”. In practice, this has resulted in theoretical proposals for “desirable” forms of state intervention that are far too general, confused, and imprecise. This is true not only of efforts to define the general economic goals of the state [3], but also, as some of the research of Wilson (1989) has shown, of the description of particular tasks to be carried out by designated government institutions.

We draw particular attention to the problem of the stimuli motivating politicians to seek additional evidence. In the theoretical model of competition between private entrepreneurs (in a branch of the economy where there is freedom of “entry” and “exit”) it is assumed that participants in the economic process can, by trial and error, discover what additional possibilities are available for carrying out commercial operations (more) effectively. Competition in the political sphere in non-democratic countries is limited, but even in democratic societies competition does not always allow for an exhaustive study of the preferences of the population or for an understanding of how best to cater for their needs. Furthermore, in the course of political manoeuvring, participants will often deliberately avoid incurring any risks that might arise if they were to defend a strategy they suspect lacks support amongst the electorate or from seeking out alternatives. [4]

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[3] In the past, ostensibly rigorous theories such as the theory of “maximization of the social welfare function” were utilized to this end. Following the publication of the work of Arrow and others this theory went out of fashion, though it now seems to be returning “through the back door”. In macro-economic theory the question of the invalidity of constructing functions of social welfare is being elegantly circumvented by the claim that the entire economy can be viewed as a representative agent (Lohmann, 2008, p. 526).(Citation needed)

[4] Some authors have noted an effect of “structural ignorance”, noticeable on occasions when information on methods that could be considered superior, by economic standards, are simply not taken into account by politicians: the question of their superior or inferior effectiveness is deemed to be “irrelevant” (Boettke et al., 2007).

In this connection, let us return go the problem that already been mentioned and that was formulated by Tullock – the problem of the indicators for measuring the economic activity of the state. Some proponents of the theory of social choice, convinced of the validity of an analogy with the market operations of the private entrepreneur, see differences only in the sphere of success indicators.

For example, comparing the activity of the private corporation with that of the state. Ronald Wintrobe writes: "It is clear that in both cases there is a satisfactory measure of efficiency – profit in the case of the [private firm, and popularity, as measured by election results or public opinion polls, in the case of the state" (Wintrobe, 1997, p.444). But even the founders of the theory of social choice noted the artificial and conditional nature of all comparisons between the political processes of "representative democracy" and the mechanisms of the competitive market (Downs, 1957. pp. 17—19).

At this point it is sufficient to note the imperfections of the political processes in question, to the excessive tendency to "aggregate", to lags in response time, and to the overall destructive effect of populist policies upon the kind of political cycles that are inevitably generated in such circumstances. If "popularity with the electorate" is a measure of the correctness of a policy, then we shall no doubt have to reconsider the value of predictions by the expert community ("scientific assessments" as they used to be called) of the long-term outcomes of government policy.

Problems of funding

Let us assume that the preferences of the population have been identified. Amongst the mechanisms that will the state to cater for these preferences funding mechanisms are particularly important.

In a seminal work on "just taxation" Erik Lindahl put forward a theoretical model in which it is assumed that the total of taxes paid by each taxpayer depends directly upon their preferences (Lidahl, 1919). This approach simply applies to the sphere of public finance the usual principles of market relations between private persons and treats a tax as the individual ("personalized") price levied for a service delivered by the state. But under this model individuals (or companies) who do not obtain sufficient benefit from a service delivered or do not agree with the means whereby this service is funded can refuse to pay the tax. It is clear that this ignores the most important feature of funding by taxation, its universal and mandatory character.

The need to ensure a balance between needs in the production of social goods and the resources available to cater for them is one of the most important problems in the functioning of the public sector. As early as 1776, Adam Smith discussed this question in the fifth book of his “Wealth of Nations” (Smith, 1962). Later, Knut Wicksell noted the contradictory interplay of political and economic factors in the tax-based funding of all kinds of government expenditure. The dilemma he drew attention to was that whilst an “authoritarian” system of determining taxes had to be rejected since every taxpayer had to participate in deciding upon the funding of every item of government expenditure, at the same time “every individual in the final analysis can speak only for himself” (Wicksell, 1964). This meant that any decision to raise taxes had to be taken unanimously. It is difficult to imagine how such ideas could be practically implemented.

In fact, as James M. Buchanan has pointed out, Wicksell had in mind that in the event serious tax changes could be considered legitimate only if they were supported not by a majority but by a qualified majority. Buchanan, 2008. p.991). But this idea seems insufficiently practical.

Notwithstanding the excessive rigidity of such proposals, they all accept the fundamental principle that, however involuntary contributions to the state budget might be, tax payers in democratic societies must feel that there is a direct link between deductions from their incomes and the benefits that they receive. However, even in the present day, serious antagonisms are evident between the preferences of taxpayers and the budgetary policy of the state. One example of such discrepancies (the “common-pool” problem) whereby members of the executive power are able, at their own discretion, to make expenditures from a common fund formed out of tax revenues. How this problem is dealt with in any given country will depend upon its political régime.

Efforts to optimize the financial operations of the state while taking account of existing political and economic institutions always encounter significant obstacles. Often, economic considerations are subordinated to political priorities. Many political strategists regard economic considerations as a mere irritant (though this does not prevent them from allowing state enterprises and institutions under “soft” budget constraints).

In this connection, we can point to instances where, even in peace time, demands for increased expenditure on armaments are included in the programmes of many parties and in the speeches of leading politicians. We will not repeat here the primitive Soviet thesis according to which the arms race in the developed capitalist countries served primarily the interests and objectives of the military-industrial complex. However, it would be no less inept categorically to deny the importance of lobbying by producers, amongst whom we find companies that sell arms to government. The influence of the army and of arms suppliers was always greatest and continues to be exercized in authoritarian and totalitarian régimes (in a number of developing countries it is difficult to establish the direction of cause and effect in this sphere). Here a breach of the Wicksell principle is obvious – the disconnection between benefits acquired by the commanding strata of the armed forces and by arms dealers and the tax burden imposed on the majority of taxpayers.

There is another important aspect to this problem. The absence of any meaningful correlation between the concept "adequate level of national security", on the one hand, and, on the other, hard information on such matters as the quantity of new types of weapons, size of the armed forces and development of "strategic" weaponry, means that the subject gives rise to much heated debate. The formulation of policy depends upon a huge number of military-strategic, political, economic, technical and other factors and this complexity makes it easy to argue that the defence capability of the state is inadequate. But an accelerated growth of unproductive resources can have a detrimental effect on the economy and nurture dangerous "ideological priorities" within the population.

Coordination, conflicts and rent-oriented behaviour

In theories of social welfare and analogous theoretical models, the state is often represented as a single political institution, which, for example in the theory of Max Weber, possesses a monopoly of the use of force (Weber, 1958, p.78). But the state is a fairly complicated, multi-tiered and hierarchical system of institutions. The activities of the various, often highly fragmented branches of power (legislative, executive, judicial) are seldom well coordinated and can on occasion enter into conflict.

Of course, in the political systems of the present day, "checks and balances" can compensate for some of these effects. Even so, large-scale projects often encounter obstacles in the course of implementation that stem from a conflict of interests at different echelons of the political élite. Disagreements between the executive and legislative branches of power can often betray the absence of a coherent strategy, for example as to ways of achieving balanced economic growth. These kinds of "perturbations" of the economic system, augmented by the effect of political cycles and populist policies, inevitably result in additional costs and make for a relative decline in the level of welfare.

Conflicts of this kind, which are common in political life, have been studied in detail (Blankart, 2000), so we shall limit ourselves to examples from the experience of Russian government during the 1990s. The political groups who had a majority in the Russian Parliament over a number of years implemented a populist strategy, increasing expenditures that produced dramatic increases in budget deficits. Given the extreme ineffectiveness of the taxation system, high inflation and the exhaustion of currency reserves, the inevitable result was the devastating financial and currency crisis of 1998.

In conditions where legal market transactions are possible, the conflict between regional and other private interests can be regulated by commercial agreements and appropriate Coasen "side payments". However, in the political sphere, one cannot count upon the operation of Coasean market mechanisms that will make for an optimal resolution of conflicts (Acemoglu, 2003). Applying conventional game-theory we can easily show that in such cases Nash equilibrium more often than not presupposes confirmation of a non-optimal (excessively high) number of projects and correspondingly longer time lags in the bringing of enterprises into operation. The practice in an ever increasing number of states of "log-rolling"5 merely consolidates this tendency, which usually drives state activity beyond the limits of optimality.

Models have been constructed of the contemporary political economy that have made possible a fairly accurate estimation of the influence of particular political institutions on the *"distortions" of decision-making in legislative and executive branches of government* that can be atributed to corruption. Roger Meyerson has produced game theoretic tools that analyse the influence of rent-oriented behaviour by politicians upon decision-making in a number of different electoral systems. The magnitude of equilibrium of rent significantly depends upon the intensity of competition between different social forces in the political arena: given certain preconditions, the value of rental equilibrium acquired by politicians increases inexorably as the number of electoral candidates decreases (Myerson, 1993).

A number of empirical studies have substantiated these findings. For example, the econometric calculations of Torsten Persson, using statistical data for 61 countries, have shown that raising electoral barriers and in particular the practice of voting for legislatures according to party lists, all other things being equal, makes for an increase in corruption and often enhances opportunities for the extraction of political rent (Persson, 2002). Opportunities for the extraction of rent significantly increase with the practice of lobbying and the operation of "interest groups". Political rent can also be realized in the form of contributions to electoral funds. Research has shown that financial support for candidates who are re-presenting themselves for election can exceed by 100-200 times the value of contributions to the electoral funds of rivals who have never previously been elected (Levitt,

[5] This term is used to describe agreements (usually informal) between individual members of a legislature or between party fractions involving "vote trading" to obtain the passage of favoured projects or budgetary assignations.

1998).

State procurements, entrepreneurial activity of the central government and of local authorities always directly involves a range of private interest, and, accordingly, provide ample opportunities for the acquisition of political rent. This may be why some public projects are implemented (usually at the regional or local government level) that, by all appearances, seem to have nothing to do with the delivery of social services.

Recently, there has been an increase in the amount of theoretical work devoted to methods of economic competition between the élite that stands behind the government and the élites that are successful in the economic sphere. In the work of Acemoglu devoted to economic growth this kind of competition is called "political replacement". The principal method employed in this replacement, in his opinion, consists of a variety of distortionary taxes levied by the government that reduce economic efficiency (Acemoglu, 2009. Ch. 22). We agree with this thesis concerning the negative effect of distortionary taxation and would draw attention to the existence in at least some countries of an additional, illegal, practice, namely the corrupt extraction of obligatory payments that serve to "materialize", as it were, a part of the political rent.

Such impositions are particularly significant in countries that struggle with the so-called "resource curse". Every initiative designed to strengthen the monopoly position of the state in such countries simultaneously provides additional opportunities for the acquisition of monopoly rent. (Ross, 2001). In such circumstances, opposition threatens not only the existence of the monopoly in question but also the opportunity for expropriation that it represents. Such rent-oriented behaviour on the part of politicians and mainstream civil servants inevitably results in a dissipation of material and labour resources. In the US economy, according to some calculations, the loss of value attributable to efforts to acquire political rent can amount to 12% of the total of domestic consumption (Tollison, 1997. p. 514). "Distortions" of the structure of economic transactions and the losses of welfare attributable to these distortions are particular great in countries with an expanding public sector, a large shadow economy and where corruption is widespread.

A significant number of studies have been devoted to the variety of forms of rent extraction, in particular to "protectionist" measures in foreign trade. Such sources of rent income are often extremely persistent: econometric research has very clearly identified the degree of "inertia" of protectionist policies in trade. In the domestic market the burden of resulting higher prices has to be borne by the taxpayer over many years. In some post-socialist countries, private entrepreneurs have to contend with not only measures of rent-extraction but also with "strategic" measures imposed by government in the interests of economic modernization.

The problem of rent-oriented behaviour is bound up with that of centralized and de-centralized mechanisms for regulation. As some research has shown (Acemoglu et al., 2008a; 2008b), in circumstances where economic actors are risk averse, the centralized allocation of resources and state enforcement significantly increases the temptations that civil servants are exposed to and is associated with high political rent. This in turn makes for additional costs and has the inevitable effect of reducing social welfare.

Preferable to problems such as these would be a system of "self-regulation" of market contracts.[6] Such a system would produce a much greater efficiency of resource allocation

The political process

The specificities of the political process, in particular the manner in which government decisions are adopted, are clearly of importance. This sphere of decision-making operates according to its own laws, means of justifying measures to be taken, and language, and these are fairly remote from the strict rules that govern the impact of these measures on the functioning of the economy and growth of social welfare.

We have in mind not merely the fact that theoretical models that describe the economic mechanisms designed to satisfy consumer demand simply take no account of the position of the country in the world arena, or of social assistance. Even it were the case that all "political" requirements could be at the present time unambiguously defined, there is no doubt that in the course of implementation the tasks in question only occasionally utilize methods that are effective from the economic point of view.

Political planning might take into account deals that are mutually advantageous from an economic point of view but very rarely does it take into account market considerations or the need for competition. The situation is further complicated by the fact that political manoeuvring, as a rule, is subject to constant change (the frequent change of strategy by the players is usually dictated by such developments as changes in the political conjuncture or the reconfiguration of coalitions). For this reason, there is often a "time-inconsistency effect" in the implementation of projects.

As far as limitations to effective regulation is concerned, let us note, in

[6] The system of self regulating ("self-executing") contracts is discussed in more detail in, for example, Radygin et al., 2008., Part I.

the first instance, the fairly strong institutional links that frequently exist between the government and relatively inefficient corporations, including state companies. These usually have a vested interest in obtaining various forms of support from central government. Secondly, influential politicians and senior government civil servants always need active support for “their” companies. To an even greater extent is this true of the inefficient “big beasts” - companies that are deemed “too big to fail”.[7]

Changes in the general conditions of economic development can reduce the need for centralized regulation, but the bureaucratic apparatus continues in existence, with its vested interest in preserving and extending its functions.

Administrative departments (like other state enterprises) cannot escape the functional laws that govern organizations. As the well-known sociologist, Niklas Luhmann has noted “not all forms of activity required by the system are relevant to the achievement of a particular objective…in addition to achieving their goals all systems have to devise additional strategies for self-preservation.” (Luhmann, 1964. p. 75). When it comes to dividing up the “official pie”, the goal of preserving one’s institution (one’s “company”) at any cost requires recourse to the most sophisticated of bureaucratic games.

For their part, large (“system-forming”) credit institutions and non-financial corporations can confidently rely on substantial state support if they fall into difficulties. This makes for significant distortions in the price structure in financial and commodity markets. During the recent financial crisis it was noticeable how huge losses in welfare resulted from the confidence of the largest credit institutions that they were guaranteed state support and how this consistently lowered the market price of risk.

Subsidization by the state of the largest investment and commercial banks and of a number of other corporations, in effect, consolidated the divergence between individual and social costs generated by the artificially lowered costs of risk. In 2007-2009 the “wave” of bankruptcies of individual borrowers, on a scale unseen since the Great Depression, and the collapse in prices of real and financial assets are evidence of the scale of the undervaluation of real risks. Other symptoms of this phenomenon were the “bubble” in the borrowing to fund aggressive “raider” acquisitions and all kinds of financial speculation.

Let us now consider the system for adoption of laws and decrees. In so far as “multi-stage” processes are involved, any withdrawal of political

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[7] The theoretical models that deal with this kind of interaction are outlined in, for example, Robinson, Torvik, 2005.

support by a particular party increases the likelihood of cancellation or of “compromises” that will gradually negate the intended improvements. In normal political life *the scope for operation of precisely the mechanisms that should clear the way for Pareto optimality can be reduced, or the impact of these mechanisms can often be marginalized.*

In theoretical models of decision-making in contemporary political economy it is customary to distinguish between “politicians” and “bureaucrats”. It is clear that both groups of actors can indirectly have an independent influence upon the declared priorities of government policy.[8]

Let us first of all consider the modification of the well known theoretical schema “principal-agent” as applied to the functioning of the public sector, proposed by Abhijit Banerjee. The structure of this model is unusual in that the principal actors are our old friend the “bureaucrat” and an abstract political institution that towers above him and controls him - the “state” (Banjeree, 1997). Arguably, this is a somewhat inferior version of the differentiation of the state apparatus presented in the work of Jean-Jacques Laffont and Jean Tirole (Laffont, Tirole, 1993): in their models we encounter the “regulatory agency” and the “author of constitutional rules”.

The standard theory of welfare formulates conditions for optimal improvement using the Kaldor-Hicks criteria (Jones, 2005). Using these criteria it is possible to calculate the extent to which changes in distribution introduced by bureaucrats, impacting negatively upon the movement of aggregate income, produce, as a consequence, a reduction in social welfare. In conditions in which the quantity of goods available for distribution is limited and corruption is relatively more widespread, the activity of the “bureaucrat” is particularly damaging. One of the principal conclusions of Banerjee is that: The failures of the state are most probably associated with the activity of that group within the bureaucracy that deals with the poorer strata of the population and with poor countries (Banerjee, 1997. p.1293). Another conclusion derived from this model is that insufficiently coordinated work between government civil servants (“bureaucrats”) can generate positive as well as negative externalities. In the latter case, the reference is usually to conflicts arising out of a lack of coordination between individual “bureaucrats”.[9]

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[8] This raises the question of the optimal division of government functions between “politicians” and “bureaucrats” and of appropriate measures of optimality. See Alesina, Tebellini, 2007; 2008.

[9] In standard textbooks on economic theory, negative externalities are invariably associated with “failures of the market” and these serves as an argument in favour of an expansion of the economic functions of the state.

But the problem is not confined to relations between government civil servants ("bureaucrats"); no less important are the *interactions* within political institutions of different social strata and groups and the influence of particular interest groups upon policy (a kind of "privatization of the state").

Acemoglu raises the fascinating question of the factors that account for the chronic inefficiency of economic and political institutions. In his game-theoretical models the following groups interact: 1) representatives of an abstract "élite" (presumably a group of representatives of the governing political élite); 2) a middle class that opposes the objectives of the "élite"; 3) hired labour. In this system the aspiration of the élite to enrich themselves and the tax increases that result are considered to be amongst the principal factors making for inefficiency. The self-serving policy of the élite explains its vested interest in preserving inefficient political and economic institutions. In these theoretical constructs the following conclusions ("theorems") are of interest: the longevity of inefficient political and economic institutions is in direct proportion to the flexibility with which the government manages its fiscal policy; the greater the value of rental income that is derived from natural resources, the greater the likelihood that inefficient institutions will survive.

Considerations of a purely tactical nature, aimed at "maximizing the popularity" of the government can be important in determining the choice of macroeconomic strategy. This preoccupation can give rise to the phenomenon of political cycles: let us assume that a party in power wishes to increase its chances of being re-elected. It then engineers, as elections approach, a significant reduction in unemployment and after the elections, refrains from measures that would increase employment.10

Even less productive (from the standpoint of economic decision-making) are the interactions of political forces, especially in states where political democracy is underdeveloped. Research on government policy in a number of states shows that when the main political parties reach an agreement this has damaging consequences for the economy. Government that is incompetent from an economic point view will impose costs upon an economy but may have political advantages – according to an authoritative survey of the practice of government in developing countries. (Baland et al., 2010. P. 4648).

[10] For more detail on the theory of political cycles, see Nordhaus, 1975; Alesina and others, 1997. Of considerable interest are the "Beta-type" political cycles which result from the interaction of many political actors (Paldam, 1997; Dinc, 2005).

As one can see, socio-political manoeuvring (to the extent that it reflects the influence of purely tactical considerations in government policy– or “short-termism”) can in many instances not only add to current economic instability but can have damaging consequences in the long term. The “dumbing-down” of political debate reduces even further the scope for implementing a coherent long-term economic strategy.[11] This means that justifications for the presence of particular projects in government policy are frequently incoherent, without foundation and lacking in economic logic.

One important aspect of the political process is the conservatism of a proliferating bureaucratic apparatus (John Stuart Mill considered bureaucratic routine to be a deadly disease) and the persistent efforts of the government élite to avoid public debate of unpopular policies. Secretiveness, which strengthens the monopoly control of politicians and state officials over information, significantly extends the scope of informational rent and, by the same token, opportunities for legal and illegal enrichment.

During the 1980s researchers drew attention to a *significant anomaly in the assumptions underlying theories of the functioning of the public sector*. On the one hand, in describing the actions of market participants, theoreticians tended to made use of a standard goal function for the preferences and interests of “homo economicus”. At the same time, participants in non-market operations were frequently presented as unselfish individuals who had no “private” interests. There were never any doubts as to their complete professional integrity (in real life these qualities are usually sacrificed to “political considerations”, for example to the need to “look after one’s own people”).

Analysis of the complex group of motives that determine the behaviour of members of the legislature and the executive leads to the following conclusion: in practice the design of a strategy and the implementation of the functions of state regulation are carried out by politicians and officials who are not always entirely professional and honest and who are given to rent-seeking and the pursuit of their own interests.[12] One only has to think of the excessive expansion of the functions of the state, a phenomenon which creates the most important means of competition between private corporations becomes access to contacts (“remunerated”) in

[11] “The public has neither the background nor the patience to digest a complicated message, so this “simplicity constraint” makes it more difficult to put together politically appealing reforms which are Pareto improvements” (Stiglitz, 1998. p. 14).

[12] On this point, the very relevant comment of Philip Selznik on non-market organizations is often quoted: The most important characteristic of non-market organizations is this that they all live their own life, even though they are all merely instruments (cited in Williamson, 1996, p.246).

the corridors of power. These practices can even further limit the effectiveness of political institutions in the economic sphere.

Priorities in economic decision-making differ in the public and private sectors. Whereas the private owner (his applies also in many cases to the manager of private property) has a direct interest in utilizing resources economically, the managers of state institutions and companies will do what ever they can to ensure that they obtain the totality of resources allocated to them. The broader the scope of state operations (the greater the volume of production in the public sector), the higher will be agency costs and X-inefficiency[13] (Vining, Weimer, 1990).

Amongst the most important factors reducing the efficiency of the work of state officials we must include the extreme aversion of the average civil servant to risk.[14] Given that the criteria used in assessing the consequences of important decisions are much less precise than in the customary economic optimization models, the number of probable undesirable outcomes significantly increases. This not only reduces the number of possibly useful initiatives that officials might take but also makes for a proliferation of preliminary soundings, agreements and other "insurance" procedures around the policy which have the effect of reducing its impact.

The monopoly status of particular government departments and the absence of market competition does not mean that there is no inter-institutional rivalry. As they strive to extend the range of their activities and influence in a context of limited budget resources, many state institutions seek to marginalize or stifle the activity of other institutions or departments. Intra-departmental and inter-departmental conflicts reduce opportunities for working together and this also reduces the effectiveness of the policy being pursued.

Overall, given the importance of the state in the modern economy, it seems fair to conclude that corruption, bureaucratic routine and conflicts within the apparatus of the executive branch of government are no less of a problem than the lack of coordination that is often held responsible for "market failures".

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[13] "X-inefficiency" is a term invented by the American economist Harvey Leibenstein to describe a situation in which the aggregate costs of a private company exceed optimal costs. This kind of inefficiency is usually due to a weakening of the competitive mechanisms that contribute to market discipline.

[14] "Risk" in this context is not to be confused with "economic risk" as understood in economic theory.

Interdisciplinary analysis and the problem of self-definition

Since publication of the works of Ronald Cause, economists have paid greater attention to the impact of legal norms and institutions on resource allocation. Many works have been published on the economic bases of property laws, on the legal-organizational forms of entrepreneurship and on aspects of the law of contract.[15]

John Locke defined political power as the right to create laws for the regulation and protection of property (Locke, 1988. Vol. 3. p. 343). Leaving to one side the standard neo-institutional list of functions exercised by the state, we can safely say that the state, one way or another, bears responsibility for a significant number of components of the "institutional matrix" of economic activity, that is, for the range of variables that make up the interaction of the population, resources and technology in the economy. (Cameron, 2001, p.22-23).

A number of state functions have a significant impact irrespective of the model of regulation. Firstly, the state ensures *a degree of continuity and stability,* without which society would be threatened with disintegration (provided the methods employed do not conflict with the needs of economic development and dissemination of technology). Secondly, the state can accommodate *institutional innovations* the results of which can equal the impact of technological innovations in enabling the more effective utilization of factors of production. Thirdly, the state can guarantee *the rights of private property and the protection of life and property through the rule of law* while refraining as far as possible from interference in the functioning of the market. Fourthly, the state can *guarantee the competitiveness of the market.*

E.G. Yasin (2002) has provided an authoritative definition of the nature of state intervention ("the burden of the state".) in Russia during the transition period. In addition to the total of federal and regional government expenditure and expenditure from a variety of funds, the burden of the state is augmented by the existence of a huge public sector in the economy- a sector that is responsible for the inequality of competition and of market relations. Finally, there is the informal influence that state institutions and their representatives exercise on the economy. This influence is brought to

[15] In particular the works of Andrei Shleifer, Rafael La Porta, Florencio Lopez-de Silanes and Simeon Djankov, notably 'Law and Finance' (La Porta et al., 1998), 'Courts' (Djanov et al., 2003) and works on forms of corporate property in the modern world and on the legal protection of investors (La Porta et al., 1999, 2000).

bear in three areas: in the "white zone", through excessive regulation, the creation of administrative barriers and the abuse of power; in the "grey zone" – through compulsory charges on business for "deserving purposes"; and in the "black zone", through corruption, and through bribes taken by officials. Taking the components of the "institutional matrix" referred to above as indicators of the long-term goals of socio-economic policy, the results of recent years lead to the conclusion that either the state lacks a coherent conception of what the interests of society are, or that, at the very least, there are confusions and ambiguities in the implementation by the state, as regulator, of its proper functions.

This state of affairs is attributable to the fact that there is only a *pretence* of regulation in an entire range of important sectors,[16] to the application of double standards to different groups of economic actors and to a deep internal conflict of interests within the state in its capacity as legislator, regulator and economic actor. In the language of political psychology, this is the problem of *self-definition of the state as a regulator* that has reached a critical level. To a certain extent this is due to the inadequacy of those stabilizing mechanisms (including political institutions) that should provide checks and balances between the aims of the state as a social institution and the goals of its agents. Let us consider a few examples from the sphere of corporate relations in Russia during the 2000s.

Formally, there has been progress in a number of areas of institutional reform. Amongst the most important achievements of the 2000s were: amendments to the law "On shareholding companies" between 2000 and 2012; amendments to the laws on privatization in 2010; the law 'On State and municipal unitary enterprises' of 2002; the law 'On bankruptcy (insolvency)' of 2002 in its redaction of 2008; the drafting of a new summary of legislation on competition between 2005 and 2011; the adoption in the summer of 2006 of the Conception for the improvement of corporative legislation; the drafting of procedural innovations with regard to the avoidance and regulation of corporate conflicts between 2006 and 2010; the draft Conception for the development of legislation concerning legal persons of 2009; and the positive legal innovations contained in the "anti-crisis package" of 2009-2010. What is noticeable is that this legislation addresses problems that arose in programmes for socio-economic development during the 2000s. As can be seen from an express-analysis of programmatic documents for the period 1999-2012, basic goals have not significantly

[16] There can be two kind of such pretence: in relation both to a narrow group of large-scale companies and monopolies, and in relation to small businesses the appearance is given of regulation, whilst in reality it is not practiced. The motives are different in each case, however.

altered.[17] The Draft 'Basic objectives of the activity of the Government of the Russian Federation for the period to 2018" to a certain extent takes into account the ideology and applied recommendations of expert groups who took part in the drafting of the revised "Strategy for the socio-economic development of Russia to 2020" ("Strategy-2020"). However, it is by the translation of these recommendations into acts of legislation that the success of this strategy will be judged.

To conclude that there is stagnation in the field of institutional reform (indeed, stagnation that has been programmed into the ten years that lie ahead), would be incorrect. Even so, our assessment reveals a low level of legislative and regulatory activity and this will mean a lack of real *progress* in the development of economic institutions in the long-run. Moreover, many of the changes that have taken place cannot be described as "innovative institutions" with a broad sphere of application, but as targeted, narrowly based measures, adopted within a state-capitalist framework of "the state for the state".

For example, take the results of the implementation of the Conception for the development of corporate legislation to 2008. The most urgently needed measures were those concerning the arbitration and avoidance of corporate conflicts (the degree of implementation was 60%). This can be attributed to the exceptionally high level of public concern about "raider" acquisitions during the period 2003-2007. Measures relating to corporate governance, notwithstanding the predominance of such measures in the Conception, achieved only 30% implementation; and measures relating to the organizational-legal forms of juridical persons, approximately 20%. Of measures that had been accepted in principle, the lowest degree of implementation was achieved in such areas as regulation of affiliated persons, conflict of interests, distribution of profit, and activity of integrated business structures, non-commercial organizations and groups of associated persons. It was precisely in these areas (Yasin's "grey" and "black" zones), that there was the greatest need for progress.

The new Conception for the development of legislation concerning legal entities, adopted in October 2009, envisaged the transformation of state corporations and the introduction of additional accountability for the founders of legal entities and for beneficiaries and individuals in control of companies, and a change in the rules for registering legal entities.

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[17] In official programmes (action plans, Conceptions) for 2000-2001, 2002-2004, 2006, 2008, to 2020 (in the redaction of 2008), to 2018 (in the redaction of 2012) we encounter key objectives in the following areas: "Privatization", "Management of state property"; "Corporate governance", "Bankruptcy", "Development of the financial market", "Development of the market in land and housing".

Subsequently, a number of measures adopted somewhat altered the corporate "landscape", but on the whole, the majoritarian model of corporate governance of the 2000s, which does not significantly limited the power of the leading shareholder, remained practically unchanged.

The new edition of the Civil Code of the Russian Federation (2008-2011) drafted by the Council for the Codification of Civil Law amends company law more significantly and exercises an indirect effect on property law and the defence of property. In the opinion of the Institute of Corporate Law and Governance, the most controversial innovations are: removal of the concept of the "corporate shield" (norms concerning the responsibility of individuals who have the power to determine the behaviour actions of the juridical entity and the subsidiary responsibility of shareholders - a conception that is absent in foreign legal systems); an increase in the degree of judicial discretion over a wide range of issues (including instances where is reference to concepts and institutions for which there is no clear legal definition); and a change in the procedure for restructuring legal entities (which provides increased opportunities for corporate blackmail and aggravates the already existing imbalance in favour of creditors).

During the 2000s, modernization of the regulation of corporate governance was debated primarily in terms of cosmetic legal changes, whereas what was need was systematic reform. The absence of such essential external mechanisms as a securities market, the institution of bankruptcy, a market of corporate control, cannot be compensated for either by control by banks or by standard mechanisms of self-regulation (given the existence of "puppet" boards of directors and the powerlessness of minority share-holders at a time when the majoritarian model was being implemented). Genuine reform requires both a review of the role of the board of directors and an activation of the regulatory functions of external mechanisms of corporate governance. All of this applies in equal measure (with due regard to the economic importance of the state sector) to optimization of the system of governance in the mixed sector of the economy. Essentially, all discussions in recent years have had to do with a search for an optimal structure for the board of directors, in respect to the size of the board, and the powers and accountability of independent directors. In discussion, what is not taken into account is the obvious conflict within a mixed-ownership company between the long-term interests of the state shareholder (ideally these interests should be embedded in the development strategy of a company and reflect the reasons for its being kept under state control) and the short-term (commercial) interests of the private minority shareholders.

In a mixed-ownership company, the board of directors should not be a structure reflecting the interests of the state as majority shareholder, but an effective instrument for working out compromises from a standpoint of "positive conflict". The framework of rights and obligations of the board would then rest upon two sets of principles: “independence, influence and access to information”; and “rights, reputation and civic responsibility”.

Without this kind of reform it is difficult to envisage any kind of progress between 2012 and 2018 in the proposed “great privatization” (to the extent that this is aimed at attracting private portfolio investment) or in acquiring for Russia the status of an international financial sector. The absence of any progress towards reform can be attributed to the absence of an adequate understanding in official circles of the role and strategic functions of the state sector and of the related tasks for retaining adequate mechanisms for direct state participation in the largest companies and banks. It is hard to avoid the conclusion that the consistent *deformation of corporate relations in favour of the majority shareholder and of the directorial model* is a direct product of the ideology of “the state for the state”.

Proposals for bringing order into the expansion of the state sector and placing all measures intended to achieve this objective into a “red zone” of economic policy were boldly pronounced in programmatic documents during 2011-2012, but with the exception of those measures relating to privatization, have never been translated into law. Even so, there continues to be an urgent need for measures enabling the downsizing of conglomerate state structures (the separation out of sub-holdings), the disposal of assets irrelevant to the core business, for legal restrictions on the future formation of state integrated structures and on the acquisition by state companies and their affiliates of new assets, especially their participation in privatizations in the capacity of buyers. Meanwhile, confusion as to the role of the state sector has meant that since the mid-2000s there has been a parallel trend involving the formation of “developmental institutions”. An ill-defined strategy that envisaged “general institutional support for effective projects” has meant rather “every project should have its own institution”. Usually the option that, superficially, seems the easier, is chosen.

In policy documents, “state corporations” (formed for the most part during 2007-2008) are presented as being transitional forms, intended to facilitate the consolidation of state assets and improve the efficiency of the strategic management of these assets. It is declared that once these aims have been achieved, as institutions for the regulation of the corporate sector are strengthened, and as the financial market develops, a number of state corporations will become shareholding companies and then be fully or partly privatized. Those that had been created for a limited time period will be wound up.

Leaving to one side the peculiar legal status and the effect of flaws in the financial and managerial design of the “state corporation”, some of which were corrected during 2010-2011, let us focus on the main issue which is the exceptional vitality of this construct, which exists in a variety of designations. As early as 2009 a new legal-organizational form made its appearance – “Russian Auto-Routes” – a “state company”. The formal differences between “state company” and “state corporation” (a management board of trustees, property acquired not only from the property fund of the Russian Federation but also constituted or acquired by its own activities) did not, in our opinion, provide sufficient grounds for the creation of a separate legal entity. However, in terms of the policy “every project should have its own institution”, the simultaneous renunciation of the “state corporation” and the need to retain freedom of manoeuvre in the future, the creation of this new legal entity is understandable.

Be this as it may, 2010 witnessed a new attempt at reform: both the state corporation and the state company “Russian Auto-Routes” were to be either reconstructed, reorganized or wound up, and when a new organizational form was introduced into the law of the Russian Federation - the “public-legal company”, The Bank for Development and Foreign Economic Activity (*Vneshekonombank*) and the Agency for Deposit Insurance were to be reconstructed and to acquire this status.

According to the draft Federal law “On public-legal companies in the Russian Federation” this entity would be a non-commercial organization, formed by a decision of the government or by a Federal law, and it would carry out its activity in the interests of the state and society. It would have special legal status and special state-derived authority. This new entity as far as one can judge, will require a very comprehensive legal underpinning that goes beyond mere correction of the flaws inherent in the legal status of its predecessors, since the new entity is unusual in Russian law and this will give rise to many difficulties.

The logic of this draft law is unquestionably at variance with the key long term objective of creating an “institutional environment” and “institutions of innovation” in the broad sense of the term. When “narrowly focussed” legislative decisions that ignore the long term interests of economic actors become the general norm a significant risk is created of a *distortion of legal decision-making.* There is an obvious example in the sphere of land ownership. In the Krasnodar and Promorie Territories the local authorities were given special authority for the acquisition of land in connection with two international projects – the Winter Olympics in Sochi and the Asia-Pacific Forum. In practice this means paying compensation and plots of land at the discretion of the authorities. In the Land Code of the Russian Federation there were no provisions for compensation in such circumstances (payment according to market value, allocation of plots of land according to choice). In 2007 particular developmental institutions and state companies had been given the right to acquire plots of land in particular economic zones outside of competition. The same right had been given in 2008 to the users of mineral resources. The state company “Russian Auto-

Routes" was granted the right to acquire land and property bypassing the executive authorities at all levels and also local government. Such decisions are not entirely negative in their effect but one consequence has been that an increasingly significant segment of the market is removed from general regulation.

There is another example in the field of bankruptcy procedures. Here two parallel trends became typical. On the one hand, around 2004, conditions were created ensuring the inviolability of large-scale assets in state ownership: state corporations were granted exemption from the effect of the law on bankruptcy and it was made easier to classify enterprises as being of "strategic" significance. Control over the activity of arbitration managers was increased in circumstances where any degree of secrecy was involved. On the other hand, right up to the crisis of 2008-2009, practically no steps were taken to develop mechanisms for the restoration of solvency and the rights of debtors became increasingly restricted. Although in the conditions of the crisis judges acquired considerable discretion, including discretion to favour the interests of debtors, and there were instances of pressure being exerted by a number of large-scale debtor companies, the legal adjudication of relations between creditors and debtor companies increasingly tended to favour creditors. A significant number of "anti-crisis" measures were drafted that favoured the interests of the state sector and of big business. Now, in the first place, the activity of such companies extends over a significantly greater number of economic agents; secondly, there was a tendency to attach greater importance to current problems and ignore the impact of the measures taken on the prospects of the entrepreneurial sector in the post-crisis period. A risk arose, therefore, of imbalances in the system of regulation and of inconsistencies in the defence of the interests of the opposing parties (See Simachev et al., 2009).

Highly indicative of the situation was the regulation of mergers and acquisitions. During the 2000s conflicts of interest frequently arose *within the state* - the state would be involved simultaneously as legislator, regulator and active player in the market of corporate control. During 2008-2009 anti-crisis measures aimed at simplifying the process of merger and acquisition were introduced – these measures were objectively necessary to optimize of the activities of companies in crisis –alongside measures facilitating the acquisition of assets by state companies and banks. Measures to limit the misconduct of debtors, arbitration managers, valuators and self-regulatory bodies resulted in a restriction of the rights of the first and in a facilitating of the transfer of disputed assets to enterprises in the mixed sector of the economy. The effect of this kind of ambivalence was a continuing lack of transparency and a relatively high degree of inefficiency in anti-monopoly regulation.

Conflicts of interest are also apparent in the financial market.[18] Extremely important decisions on regulation were taken in 2010, imposing stricter professional conditions on participants and on their own capital value, prohibiting the manipulation of prices of financial assets, bringing forward consolidation of the infrastructure of the stock market and introducing norms for prudential oversight. The effect of this could be said to be a strengthening of the role of the state in the stock market, for the direct intervention of the state in the business of professional participants.

In this context, the experience of the Bank for Foreign Economic Activity (VEB) in implementing anti-crisis measures to support the domestic stock market in 2008-2009 is of relevance. Although there has never been any public report on its interventions and of the sale back of shares, it is our understanding that in October 2008 VEB received, for the purposes of support of the stock market a subordinated loan of 175 billion roubles at an annual interest rate of 7% which it repaid to the state with interest on 15 December 2009. In its annual report for 2009, the Bank wrote that it had sold part of the packet of shares purchased with this loan from the National Welfare Fund (FMB) in the second half of 2009. However, during this period (with the exception of July) there was no recorded increase in the activity of state institutions in the stock market, by contrast with the period when VEB acquired the shares. A removal from the market of 6 billion dollars between July and December 2009 would have affected the smooth upward trend of the market. However, there was no perceptible effect. We can conjecture that by no means the entire packet of shares acquired with the funds of he FNB was sold by VEB, and that 175 billion roubles was repaid to the RF Ministry of Finance at the end of December 2009 using funds from different sources. In general, the financial intervention of the state to support the market was not justified. This intervention perhaps slightly attenuated the fall in the market but it did not influence the direction of the trend. The outcome was not so much effective state support to the stock market and investors as a successful "marginal" deal by the state bank utilizing a loan provided over an attractive time period and at a favourable interest rate.

The inter-institutional struggle for control in this sphere that has prevailed over the last twenty years and the period return to the idea of a "mega-regulator" will hardly contribute to stability and an improvement in the quality of regulation.

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[18] For more detail, see the materials of A.A. Abramov in the economic surveys of the Gaidar Institute of Economic Policy for 2010 and 2011 (www.iep.ru).

Nothing that has been said here concerning the “failures of the state” is intended to argue that the involvement of the state in the economy brings only harm or that all politicians and civil servants are corrupt.

Research into the “failures of the state” should not descend to the level of popular “exposé” or be oversimplified as a confrontation between “statists” and “free marketeers”. Nor should such research be used to support fundamentalist arguments in favour of one type of economy or the other. In present-day conditions, this kind of comparison makes no sense. What is at important is the practical problem – how are we to decide what interests the state should support? We should not be arguing over whether the state should or not intervene in the economy (Radygin et al., 2011). What is important is the need to elaborate *a new strategy of political-economic research into the mechanisms of resource allocation and into the impact of social institutions that have been inherited from the past upon the efficiency of economic processes.*

For a variety of reasons economic theory has until very recently devoted insufficient attention to the economic consequences of the interaction of particular social and political factors. We know that the political process has its own logic and in many areas this logic does not contribute to what is required for the optimization of economic activity. Politicians and civil servants are not often required to take into account circumstances that affect economic efficiency. Often, the scale of economic inefficiency and waste is multiplied by the effect of oligopolistic structures that have become embedded in society and in political life, by insufficient coordination of the actions of different branches of the power structure and by a lack of transparency and secretiveness that are inherent in the decision-making processes of an extensive and often rent-oriented bureaucratic system.

All of this justifies analysis of those interactions in the system of economic relations that limit the possibilities for real economic growth and/or introduce distortions into the functioning of allocation mechanisms. Available evidence provides substantial grounds for a theory of “failures of the state”. It is particularly important to point out that, in addition to the conceptions of “market failure” and “failures of the state”, which have become established in mainstream economic theory, there exists the problematic of optimal interaction of mechanisms of centralized and decentralized regulation. Finding solutions to this problem of optimality will require a more general, inter-disciplinary approach in areas where political science, sociology and economics overlap.

The impact of the “failures of the state” to a significant degree depends as much upon the scope of state intervention as upon the structure of state organization, and in particular upon the historical legacy of political culture, the degree of democratization of society and the structure of social institutions. It is for this reason that in Russia a transition from the ideology of “the state for the state” to a policy of “not an all-pervasive but an efficient state” (at least in the economic sphere) is so vital.

In the more developed countries, market relations were preceded by a lengthy period in history during which certain moral-ethical norms of human behaviour became established. These norms, established traditions that are the product of many centuries of interaction of individuals and collectives, operate well beyond relations of market exchange – they define the possibilities and limits of market mechanisms of interaction and coordination.

The starting point of economic analysis is the system of individual preferences – and in real life these include various “social” preferences, which, as a rule, are not allowed for in the standard theoretical models. In the usual methods of microeconomic analysis it is difficult to find a place for the principles of the illustrious citizen of Stagira: “The virtuous citizen also does much for his friends and his native land and is prepared even to lay down his life for them if necessary: he will dispose of his property and honour and all of the good things that others cling to, retaining for himself only his moral integrity ...” (Aristotle, 1984, p. 258). Are we really to conclude that there is no place for this kind of thinking in real life?

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