

Misuse of Institutions: Patterns and Causes

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Abstract: Institutions are often misused, i.e. applied or resorted to for reasons which have little in common with their intended *raison d'être*. This paper provides an insight into the origins and causes of institutional misuse and explores the political economy of this phenomenon. We present a typology of misuse of institutions and illustrate it by examples largely drawn from Russian realities. Causes of vulnerability of institution to misuse are discussed. It is argued that institutions are not protected from misuse at the grassroots due to unresolved collective action problem, whereas economic and political elite are either indifferent to misuse of institutions, or perpetrate such misuse by subverting market institutions for the purpose of rent extraction.

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1. Introduction

Key role of institutions for development is rarely questioned, but interpretation of this general dictum remains a challenge. First, conventional “best practice” institutions often fail to deliver the expected outcomes, hence the conclusion that to work well institutions should be customized to local conditions. This conclusion however in and of itself does not explain what exactly is wrong with non-performing institutions and why they do a much better job under some circumstances than the other. More in-depth analyses invoke such explanations as cultural rejection and “bad fit” (Cooter, 1997; Rodrik, 2000; Polterovich, 2001; Berkowitz, Pistor and Richard, 2003); inconsistency of a given institution with the rest of the institutional setup and gaps in such setup which due to complementarities adversely affect the existing institutions; multiplicity of equilibria and “institutional traps” (Hellman, 1998; Roland, 2000; Polterovich, 2006). Still, attempts to look into the “black box” to better understand how institutions fail remain relatively few.

Second, ambiguity as to what makes for a good institution complicates empirical proofs of the causal link between institutions and growth. If one gives up on spelling out an “exogenous” definition of a good institution and instead characterizes such institutions “endogenously” as those sustaining growth, then the causality becomes tautological. Many measures of quality of institutions are suspected to be influenced by the overall perception of a nation as prosperous or

poor (“halo effect”; see e.g. Bardhan, 2005), or reflect not the underlying institutions but *outcomes*, whereas institutions per se, such as laws and constitutional norms, show no systematic impact on growth and welfare (Glaeser et al, 2004; Przeworsky et al., 2000). Moreover, economic order and real allocation of power sometimes exhibit low sensitivity (“invariance”) to evolving formal institutions (Weingast, 1997; North, 2005; Acemoglu and Robinson, 2006) which can be manipulated to preserve the status quo.

A useful insight into some of such puzzles can be obtained by simply noting that institutions can be *misused*, i.e. applied or resorted to for reasons which have little in common with their intended or anticipated purpose. Efficiency-enhancing institutions are expected to serve as public goods – they create value for communities of users and beneficiaries by supporting production and exchange, reducing informational asymmetry, cutting transaction costs and otherwise averting market failures. However once in place, an institution affects expectations, costs and benefits of certain activities and opens up heretofore unavailable avenues for seeking personal gains. This could produce incentives for misuse of an institution by exploiting opportunities that it creates in unforeseen ways unrelated to the institution’s primary *raison d’être*.

If incidences of such misuse are limited in scale, the institution is not undermined in its key capacities. However when misuse becomes unchecked and widespread, it could render the institution dysfunctional by compromising its reputation, crowding out legitimate users or through subversion by opportunistic interests. In such case an institution that works well when used properly fails due to massive misuse, which is often interpreted as an evidence of “bad fit”. Consequently the presence of such institution does not advance growth and welfare and could even be a source of efficiency losses – hence the difficulties of empirical confirmation of the link between institutions and development. Indeed the mere availability of an institution in and of itself does not ensure growth – of equal importance is whether the institution is used properly or broadly misused.

Misuse of institutions is but one type of a failure to advance development by means of institutional reform. Other patterns of such failure according to (Polterovich, 2001) are atrophy of an institution which condemns it to eventual demise, or emergence of alternative arrangements which suppress an unsuccessful institutional innovation and lead to its rejection. Other possibilities include degeneration of an atrophied institution or a conflict between a formal institution and informal routines and conventions, both leading to misuse of institutions. In our case an institution is neither neglected (which would lead to its atrophy) nor rejected; in fact it is used, sometimes quite actively and massively, but in a wrong way.

Examples of institutions crippled by misuse abound; elsewhere (Polishchuk, 2008b) we presented a typology of institutional misuse and illustrated each type by cases drawn from Russian realities. The purpose of the present paper is to get a further insight into the origins and causes of institutional misuse and explore the political economy of this phenomenon.

2. Typology of misuse

Few institutions are immune to misuse which is driven by various incentives, takes multiple forms and produces diverse outcomes. A structure in this disparate family of institutional pathologies can be provided by the following typology which comprises four patterns of misuse of institutions:

- Exploit of asymmetric information
- Manipulation by institutions
- Institution as cover
- Institutional capture

In the first of these categories unscrupulous agents pretend to follow rules of an institution but in fact violate those rules and accrue gains due to a failure to observe and sanction such violations. The second type is about using an institution to justify activities that are in compliance with the letter of the institution but frustrate its spirit and purpose. The essence of the third pattern is to hide illicit activities “in the shadow” of an institution. Finally, in the fourth version an institution is subverted by a group which turns it from a public good into a source of rent at the expense of the rest of society.

In what follows the above patterns are described at greater length and illustrated by cases drawn from the recent history of institutional change in Russia.

3. Exploit of asymmetric information

An important function of institutions is to reduce uncertainty in economy and society. This is achieved either by setting rules and norms of behavior or by providing for reliable disclosure of asymmetric information. In the latter case an institution allows to send a signal of otherwise unobservable characteristics or behavior. Obviously the value of such signal depends on the strength of the institution’s internal and external control mechanisms. When these mechanisms malfunction, public trust in the institution can be exploited to mislead the society about the true type of an agent and his/her behavior. As the number of violators grows bigger, confidence in the institution progressively declines and the institution is losing its reputation – an asset critically important for the ability to serve as a credible signaling device.

This process can be illustrated by the *institution of non-profit organizations*. A well-known comparative advantage of non-profits over for-profit firms is that the profit non-distribution condition allows the former to provide additional assurance to customers buying goods and services of uncertain quality (“credence goods”). According to (Hansmann, 1980), the non-distribution condition reduces the incentive to cut costs by lowering unobservable quality and

thus taking advantage of informational asymmetry. This explains the observed prevalence of non-profits on the credence goods markets.

Maintaining reputation for quality is essential for non-profits' competitiveness vis-à-vis conventional for-profit firms. However if the non-distribution constraint is not properly enforced due to weakness of internal and external control, impostors can enter the non-profit sector and take advantage of its statute and reputation without following the rules on which this reputation rests. The institution of non-profits can be abused for material gains, tax evasion, money laundering and other purposes by bending (or even breaking) the rules that govern the sector (see e.g. Gibelman and Gelman, 2004). In an ensuing pooling equilibrium bona fide NGOs co-exist with opportunistic organizations. When misuse becomes widespread, credibility of the non-profit sector deteriorates.

Bona fide NGOs suffer as a result of such confidence crisis – they are forced to reduce the scale of their activities and/or quality of goods and services, since the skepticism of customers and donors does not generate sufficient revenues to allow cost recovery at the previously available level. Another group of victims are customers of NGOs who are denied access to quality services provided by the sector. Such losses are partly captured as rent by those misusing the institution; however this rent progressively dissipates as the entry of violators continues, and this process leads to a steady-state in which the NGO sector is nearly dysfunctional and failing to perform its role in the society (Polishchuk, 2008a).

This scenario unfolded in Russia until the government steeply increased reporting and regulatory requirements for national NGOs. The remedy however proved to be too radical as it led to a dramatic decline in the ranks of Russian non-profits which found the cost of compliance with new rules prohibitively high. It is unclear whether the measure indeed contained the misuse of the NGO status, since there is a “negative selection” at play – pseudo-NGOs that were able to successfully manipulate the old rules obtained comparative advantages over bona fide non-profits in navigating through the newly introduced stricter requirements.

A similar illustration is provided by the institution of *post-secondary education* in Russia in the 1990s – early 2000s. Uncontrollable proliferation of private universities and colleges (all of them de jure non-profits) and commercialization of public universities were driven to a large extent by profit-seeking motive. Vigorous competition between schools dramatically *reduced* academic standards and quality of education, as universities and colleges were luring in prospective students by promising degrees that would require minimal time and effort and virtually guaranteeing graduation to anyone paying tuition. Such process devalued the post-secondary degree as a signal of knowledge and ability (transforming this type of signaling into, almost literally, “cheap talk”), but did not render degrees completely worthless due to the presence among the degree holders of more capable and better educated individuals (Polishchuk and Livny, 2005). The diminishing premium that such degrees earned in the labor market

sustained the expansion of the post-secondary education sector, until the willingness to pay for an increasingly worthless diploma still covers reduced costs of operating a university. The ability of such educational system to accumulate human capital was obviously severely compromised.

4. Manipulation by institutions

Formal institutions are usually established by legal acts. However laws are “incomplete contracts” and often leave grey areas which are open to interpretation. Width of such areas depends on a legal system – the civil law family is based on more or less clearly established “bright lines rules”, whereas the common law is guided by general legal principles (Glaeser and Shleifer, 2002), but in all cases gaps in written laws are filled by courts that are supposed to be guided by the intent and purpose of the law. When such interpretation is not sufficiently consistent, incompleteness of laws makes them vulnerable to manipulation, whereby the letter of the law is observed but its spirit violated¹. Opportunities for such misuse of law depend on its quality and precision as well as on professionalism and independence of courts. With these conditions absent, laws and institutions that they are expected to support are prone to manipulation. Such manipulation is invited by a lack of *legality*, defined in (Berkowitz, Pistor and Richard, 2003) as effectiveness of law and its enforcement in serving its intended purpose; legality implies in particular that legal professionals applying a law are guided not just by its wording but also by the underlying concept and purpose.

A case in point is the Russian *bankruptcy law*. The institution of bankruptcy is a critically important ingredient of the modern market economy – it protects creditors and thus facilitates access to finance, creates incentives for efficient corporate governance, improves financial performance and resource allocation in the corporate sector. At the same time this institution can be exploited by “corporate raiders” for takeovers of sound businesses, for asset stripping and other attempts on property rights, which defy the purpose of the bankruptcy law by disrupting corporate governance rather than improving it. All of the above could be accomplished by invoking the bankruptcy law in cases concocted to technically fall in the law’s confines but in their substance not calling for bankruptcy. Such misuse is possible when corporate sector lacks transparency, and courts are weak and prone to corruption and political interference.

In Russia misuse of bankruptcy became widespread in the late 1990s. When a bankruptcy law was first introduced in the country in the early 1990s, it was rarely used due to excessively stringent qualification requirements that had to be met to initiate a bankruptcy process. To facilitate badly needed restructuring of Russian firm, the threshold of law application was lowered, and that indeed had triggered a wave of bankruptcy proceedings. However contrary to the intent of drafters much of bankruptcy cases were opened against economically sound firms that attracted raiders’ interest, whereas loss-making and debt-ridden companies that were the intended

targets of the institution of bankruptcy were rarely touched. According to a Russian analyst, an “industry of property expropriation through bankruptcy” opened up that processed about 30,000 “contracted bankruptcies” per year². Analyses show that the law did little to protect creditors’ rights, tighten budget constraints and facilitate restructuring, but helped violate property rights and sustain inefficient management practices (Lambert-Mogiliansky, Sonin and Zhuravskaya, 2003; Radygin and Simachev, 2005).

The ease of invoking the law due to a low application threshold was a key factor in the massive misuse of the institution of bankruptcy. A failure to prevent misuse (in large part due to inability of the court system to safeguard the institution) left the country with a grim choice between an institution which is either defunct, or vulnerable to massive distortion and capture. An attempt to resolve this dilemma was a yet another revision of the bankruptcy law which again tightened the requirements that have to be met to initiate a bankruptcy. As it was the case with a similar measure to arrest misuse of the institution of non-profits, this attempt was not entirely successful as it led to delays of bankruptcy cases initiated with good reasons, whereas raider attacks continued unabated, albeit by resorting to other types of corporate law. Apparently a blanket increase of the “entry barriers” complicates access to the institution of bona fide users, while opportunists that manipulated the institution earlier are able to successfully adjust to the new rules of the game. Courts that would normally prevent misuse of bankruptcy without incapacitating this institution failed to perform this role by succumbing to outside pressure and interference (Lambert-Mogiliansky, Sonin and Zhuravskaya, *op. cit.*).

5. Institutions as cover

In some instances an institution could be used to conceal under its veil socially questionable activities that cannot be conducted in the open. Institutions are misused to hide the dark side of such activities and represent them as legitimate and sanctioned by institutions—“covers”.

Such pattern can be illustrated by misuse of *corporate social responsibility*. Modern corporations broadly subscribe to the concept of socially responsible conduct which takes multiple forms, ranging from voluntary compliance with heightened environmental, social, ethical etc. performance standards that exceed those mandated by laws and regulations, to various “social investments”, donations to community, philanthropic actions, etc. Such activities could help companies increase their sales and profits by strengthening consumer demand and loyalty, securing access to capital and other production inputs and otherwise improving operational conditions of the company. Corporate social responsibility can also be a reaction to social pressure which subjects corporations to “civic regulation”, forcing them to refrain from actions which are not in violation of the law on the books but considered as questionable by public opinion.

Corporate social responsibility can be misused by government officials to coerce businesses into financing projects and programs which are important for government but cannot be implemented due to a lack of conventional tax revenues. In such cases corporate donations become de-facto off-budget sources of revenues exempted from mandatory rigors of budgetary control. Such practice which became widespread in modern Russia violates principles of sound public finance and at the same time adversely affects business environment by subjecting firms to unpredictably and arbitrarily laid taxes disguised as corporate donations (Polishchuk, 2006).

There are evidences that at times corporate social responsibility is used to accommodate agreements between firms and politicians where financial support to government's pet projects is traded for preferential access to markets, resources and government contracts, as well as for tolerance to violations by companies of laws and regulations, including tax laws (this makes sense when *regional* administrations' leniency in collecting *federal* taxes is exchanged for ad hoc contributions to *local* projects). Such exchanges often undermine economic efficiency, since their parties seek gains at the expense of the society (Shleifer and Vishny, 1994). The rubric of corporate social responsibility facilitates conclusion and implementation of agreements between politicians and firms by cutting transaction costs of such agreements and presenting them in a socially acceptable and even commendable way.

Another example of using institution as a cover is misuse of *intermediaries*. Intermediaries are indispensable in modern market economies – they serve as brokers, ensure liquidity and availability of goods and factors of production, disseminate market information, provide quality assurance and otherwise support economic exchanges by helping parties to reduce transaction costs. Regrettably, this latter advantage of intermediaries could be extended on transaction costs of illicit activities – e.g. they can handle a criminal part of a transaction and disappear immediately afterwards (“fly-by-night” operations).

Intermediaries also assist in meeting legal and regulatory requirements, such as obtaining permits, licenses, custom clearances, filing tax returns, etc. Intermediaries reduce costs of compliance with government rules due to the advantages of specialization and economy of scale, and partly pass such savings onto their clients. However the institution of intermediary firms can also serve as a cover for corruption thanks to its ability to cut not only legitimate but also illicit transaction costs. Indeed, if intermediaries deal in bribes in the interests of their clients, the latter are relieved from the need to personally conduct embarrassing and risky negotiations about the size and terms of the bribe (which is included in the intermediary's fees). More importantly, intermediaries dramatically reduce risks of corruption as they are the only ones who have material evidences necessary to lodge complaints about bribes. This gives corrupt bureaucrats virtual indemnity from potential prosecution and punishment, because intermediaries obviously value symbiotic relations with corrupt bureaucracy and would not blow a whistle (Lambsdorff, 2002).

Analysis presented in Polishchuk (2004) shows that the institution of intermediaries which

normally produces efficiency gains by cutting transaction costs can aggravate damage caused by corruption. This is a possible outcome because intermediaries essentially lift the “fear constraint” that limits bureaucrats’ appetite in setting the bribe level, and allow the latter to increase the bribe until the “market constraint” determined by demand elasticity becomes binding. Such outcome is particularly likely after an administrative reform which reduces legitimate transaction costs in meeting government requirements (Polishchuk, Shchetinin and Shestoperov, 2008). In this case intermediaries provide corrupt bureaucracy with an “institutional defense” from reform – by deliberately increasing the hassle of compliance with laws and regulations on one’s own, bureaucrats prompt at least most wealthy and/or impatient among their clients to seek intermediaries’ help³. Several channels of navigating through administrative barriers – with or without intermediaries’ assistance – give bureaucracy an attractive screening opportunity which increases the corruption yield.

In both examples an institution-“cover” reduces costs of socially unproductive conduct and thus increases the scale of such activities. This pattern of misuse of institution, as the earlier considered versions, also compromises the exploited institutions and undermines their ability to serve their legitimate purpose.

6. Institutional capture

Key institutions of market economy that protect property and contract, resolve disputes, control externalities etc. have the property of public goods and benefit the society and economy at large. Such institutions can be misused by way of capture and subversion by narrow interests that convert captured institutions into “club goods” earning rents for club members. Captors can be either insiders in charge of operating an institution that are not properly controlled by the society, or interest groups of “outsiders” who were able to resolve a collective action problem and put an institution under their control.

One of the best known examples of institutional capture is *subversion of economic regulation*. The purpose of regulation is to serve public interests by preventing market failures due to externalities, asymmetric information, market power etc. The observed patterns of regulation often better conform to the “public choice” view first presented by Stigler (1971) where the institution of regulation is controlled by interest groups in the private sector or government bureaucracy.

The public choice view better explains the drastic – tenfold and more – cross-country variations of the height of entry barriers that need to be cleared by new businesses which want to operate in the formal sector. Taller barriers are not shown to yield higher health and public safety standards, more competition and protection of consumers’ and workers’ rights, etc.; rather, they are associated with corruption and sprawling shadow economy (Djankov et al, 2002). Small and

medium businesses respond to excessive entry barriers by exiting to the informal sector. The informal sector however is a highly imperfect substitute for conventional market institutions, as it restricts access to finance, does not ensure secured property rights and otherwise impedes investments and growth. As a result developing countries which cannot prevent misuse of economic regulation suffer massive losses due to a failure to provide enabling conditions to a vast majority of resource owners who are forced to inefficiently employ their assets in the informal sector (De Soto, 2000). Such outcome however benefits wealthy resource owners – the only ones able to pass the inflated entry barriers and thus earn a higher return to their assets (for more details see Section 10 below).

Similar outcomes obtain in case of misuse of the justice system through *capture of courts*. The intended purposes of courts and justice are to ensure fair and predictable resolution of disputes over torts, property and contracts. When courts are submissive to threats, bribes and/or political influence, they can be misused for expropriation of income and property through legal sanction obtained from a subverted justice system, or by denying justice to victims of expropriation.

Such outcome is likely against a backdrop of profound economic and political inequality when wealth and power create advantages in influencing courts. Disenfranchised agents cannot count on captured justice, and their economic decisions are motivated and shaped not only by conventional costs and benefits considerations, but also by the need to shield their businesses from attempts of wealthier or better connected competitors (Glaeser, Scheinkman and Shleifer, 2003). A lack of legal protection thus distorts economic incentives and hinders development by reducing attractiveness of large-scale and long-term investment projects, by constraining expansion of small firms and squeezing them into the shadow economy.

Our next example of misuse by subversion is the *capture of subnational governance* in a federal system. Decentralized system of government can produce multiple benefits such as greater flexibility of fiscal policies that could be adjusted to local circumstances, and stronger incentives for good subnational governance due to competition of regions for mobile resources and enhanced ability of voters to gauge performance of regional governments through “yardstick competition”. The essence of such incentives is direct accountability of regional governments to population which is maintained through popular vote.

However the institution of decentralized government is vulnerable to capture of political processes at the regional and local levels. Such risks are aggravated by greater likelihood of emergence in a given region of a dominant interest group, or, put another way, by relative “smallness” of regional government vis-à-vis major firms, industries and other potential interest groups in their regions (Bardhan and Mookherjee, 2000; Blanchard and Shleifer, 2001). Nationwide such groups’ influences more likely cancel off each other, thus maintaining a level playing field and reducing the odds of government capture. Political processes at the national

level are usually more competitive and are under greater scrutiny of the media, which also makes federal politics more resistant to capture.

There is ample evidence of widespread capture of regional governments in Russia, which afforded the “captors” massive rents but stifled economic growth in regions and led to costly fragmentation of the national market. A radical means deployed to overcome such capture was a far-reaching re-centralization of the Russian system of government, including cancellation of elections of regional governors by popular vote; presently regional executives are essentially presidential appointees. This move turned off powerful political incentives of the federal system that were sacrificed to prevent misuse of federalism in Russia. Here too misuse of an institution was forestalled at a high cost of suppressing the institution in the first instance.

Misuse by subversion occurs not just state- or economy-wide, but at the micro level as well. This can be illustrated by the example of the institution of *homeowners associations* introduced in Russia by a recently passed legislation. Such associations are supposed to be formed by apartment owners to jointly manage their common property (hallways, elevators, security, piping and wiring, parking areas etc.). Earlier such functions were carried out by municipal authorities whose work was notorious for poor quality and great waste and embezzlement. One could have expected that the new institution, which allows homeowner associations to choose, monitor and if necessary replace management companies and be in control of how maintenance fees are spent would be in high demand and with necessary law in place, homeowner associations would mushroom. In fact the grassroots reaction so far has been mild at best, and up to date such associations were created in only some 5% of apartment buildings (Shomina, 2008). Worse yet, oftentimes outsiders such as management companies or local government officials took initiative to establish an association, seeking lucrative opportunities and thus subverting the new institution, while its intended beneficiaries – homeowners – remained passive.

7. Why – misuse?

The above list of diverse examples illustrates how an institutional reform can produce an unanticipated and unintended outcome when newly established institutions are broadly misused⁴. Much of earlier debates on transition focused on the need to supply main ingredients of the institutional setup of market democracy; this prescription was based on an implicit assumption that the required institutions, once in place, will be functioning as intended. It appears that such outcome is anything but a foregone conclusion. An insight into causes of institutional misuse could lead to a better understanding of how to increase the odds that new institutions will be used in a conventional manner and that misuse will remain controlled and preventable.

It was argued earlier that institutions are misused in pursuit of tangible gains at the expense of bona fide users and possibly the rest of society which is denied – partly or in full – the benefits of

misused institutions. One can expect that the victims of such misuse have the incentive to protect institutions, or alternately the state will serve as institutions' guardian on behalf of the society. The scale and impunity of the reported incidences of institutional misuse indicate that often both of these "lines of defense" fail, albeit for different reasons.

8. Surrender at the grassroots

Why are institutions not defended by those who value their legitimate use and thus suffer from misuse? One can offer several plausible explanations all of which find a degree of support in the Russian evidence.

First, some victim institutions are not properly appreciated in the society and thus can be misused with impunity. Such under-appreciation could be exogenous, when a society has no prior experience with similar institutions, is not aware of their potential value and does not produce grassroots demand for an institution that was imposed on the society e.g. through transplantation or emulation. Another possibility is that the institution is discredited, perhaps by prior misuse, which denies it grassroots support and leaves wide open to further misuse. Finally, those willing to protect an institution can be disorganized and unable to mount a defense due to a failure to properly coordinate opinions and actions.

Analysis of success and lack thereof of legal "transplants" presented in (Berkowitz, Pistor and Richard, 2003) confirms some of the above conjectures. It is shown that effectiveness of introduction of new laws depends on whether such laws are meaningful in the local context, and whether there is a cadre of legal professionals willing and able to properly interpret and enforce the law. When these conditions are met, new laws are supplied in response to pre-existing demand which creates appreciation of the law and incentives to properly use it. Otherwise laws "... will either not be applied or applied in a way that may be inconsistent with the intention of the rule in the context of which it originated" (op. cit., p. 174). Cooter (1997) makes a similar point – laws stand better chances to be enforced and properly used if they reflect inherent social norms and are thus perceived as just and valuable – in this case private citizens will be assisting the state in upholding and enforcing the law and blow a whistle in case of its violation and misuse.

These explanations shed light on the massive misuse of the Russian bankruptcy law which had no precedents prior to its introduction and few proponents in the corporate sector interested in a functional institution of bankruptcy. A lack of cadre of legal professionals experienced in application of bankruptcy law was compounded by pressure on courts which adjudicated bankruptcy, exerted by government officials that "captured" the institution of bankruptcy (Lambert-Mogiliansky, Sonin and Zhuravskaya, 2003).

Similar reasons explain vulnerability to misuse of the institution of non-profit. Surveys reveal

deep mistrust in the Russian society in the country's NGO sector, and widespread skepticism in its ability to serve a useful purpose. Symptomatically respondents often cite NGOs' misuse as fronts for corruption, kick-backs and money laundering, and as vehicles for de facto for-profit commercial activities, as key reasons for denying non-profits support and respect (Report ..., 2007). Unsurprisingly, a regulatory crackdown on Russian NGOs went largely unnoticed in the Russian society.

A yet another heavy-handed correction aimed at stopping misuse of an institution with no firm roots in the society – cancellation of direct elections of regional governments – met an equally acquiescent reaction. Indeed, federal system in Russia has no solid foundations in the national political culture and no historical precedents of any depth and significance (Polishchuk, 1999). Russian federalism was in part a reaction to the egregious failures of the Soviet hyper-centralization, in part a political compromise of the early 1990s crafted to co-opt restive regional elites in a constitutional regime promoted by a weak central government. Absent social and cultural anchors, federalism-Russian style was prone to excesses in the early-to-mid 1990s with a nearly disabled federal center, and succumbed to the subsequent over-centralization when political winds changed direction. Imprecision of the Russian constitutional setup facilitated such drastic “corrections” but was by no means their main reason⁵.

Even when the value of an institution under attack is sufficiently recognized, effective defense is precluded by a lack of *social capital*, understood as norms and networks that facilitate collective action (Woolcock, 1998). Indeed, protecting an institution against misuse maintains a public good, and this requires a collective action of the institution's beneficiaries. Unless sufficient social capital is present, the free-riding problem and other impediments to collective action make an institution susceptible to misuse.

It is well-recognized in the literature that social capital is required to make full use of many of the modern institutions; in particular it enhances government effectiveness by prompting citizens to monitor government activities and take appropriate action when necessary (Keefer and Knack, 2005). Our analysis highlights an additional link between social capital and the quality of institutions by pointing out to a collective action problem of protecting an institution, not necessarily in the public sector, but still of public good nature, from misuse.

One can expect that such collective action problem, in full agreement with Olson's (1965) famous dictum, would be particularly difficult to resolve when the number of beneficiaries of an institution under attack is large. And yet a lack of social capital could cripple even institutions whose beneficiaries form a relatively compact and small group. This can best be seen from the above described widespread capture of newly created homeowners associations in Russia by local authorities and/or management companies. This example is particularly striking – several dozen tenant families of an apartment building often fail to act jointly in their immediate and tangible interests and demand accountability and quality services from a management company, thus

allowing opportunists to profiteer on the new institution at the cost of substandard management of common property. One explanation of such failure is at times considerable economic and social heterogeneity of tenants, but more likely the real culprit is “atomization” of the Russian society that denies social capital its crucially important “networking” component (Putnam, 1993).

A collective action problem that is associated with grassroots defense of an institution against misuse has another dimension – even if institution’s legitimate users and beneficiaries are willing to work in concert to prevent misuse, they need to reach a shared understanding of what activities constitute such misuse and would trigger collective sanctions. Such coordinated beliefs make an institution *self-enforcing* and according to (Weingast, 1997) provide foundation for e.g. sustainable democracy and rule of law. Shared vision of what constitutes an unacceptable transgression, and resolve to act accordingly, are ingredients of *civic culture*, and when it is in short supply, the institution becomes shaky.

Self-regulation provides a useful parallel with grassroots prevention of misuse of an institution. Under self-regulation, representatives of a particular trade voluntarily agree to higher performance standards than those that can be enforced externally by public regulators. According to Haufler (2001), self-regulation can be prompted by perceived high risk of government regulation; modest competition and high asset specificity; high business value of reputation as a key asset; and intensive communication and high level of consensus within an industry. While some of these prerequisites of self-regulation could be observed in the above examples (e.g. heavy-handed government regulation has indeed materialized in the Russian non-profit sector), others are conspicuously absent, which could explain the lack of protection from within of institutions from misuse. Thus, the Russian market for post-secondary education is fiercely competitive and until recently characterized by diminished asset specificity (professional faculty, libraries, lab equipment etc. earned little premium in the “mass production” segment), whereas the academic community was notoriously unable to endorse and enforce a common stance on educational policies.

9. Why – government inaction?

When misuse of an institution cannot be prevented by self-enforcement, government should step in as the institution’s guardian. In doing so the government would fulfill its role of public goods supplier – as it was argued earlier, this task provides not just for putting welfare-enhancing institutions in place, but also for ensuring their proper work.

In reality government’s activities are shaped by pressure of various interest groups. Analysis in the preceding section leads to the conclusion that masses are unable to form a consolidated political force in defense of institutions subjected to misuse, and the matter is often decided by preferences of political and economic elite controlling massive resources and, being much less

numerous, better able to resolve the collective action problem (Olson, 1965). Unfortunately elite cannot be count upon as institutional guardians – they are either indifferent to misuse of institutions, or, as will be argued in the next section, could be perpetrators of such misuse.

Elite’s lack of reaction to misuse of institutions seems to contradict the idea that such institutions are public goods benefiting the elite and masses alike. Several arguments explain the paradox. First, various individuals value the same institution to different extents – for some an institution could be nearly vital, for others – barely noticeable and almost never used. Thus, elite’s immediate needs in services provided by most of NGOs (social services, support to economically disadvantaged groups, protection of human rights, etc.) are obviously not particularly acute; this also includes domestic institutions of post-secondary education and health care, which powerful and wealthy sidestep by sending their children to foreign universities and obtaining treatment at clinics abroad.

Secondly and perhaps more importantly, even if general-purpose institutions valued by the society at large are also of some value for the elite, the latter have more immediate and overarching needs and concerns that top elite’s policy agenda. Such concerns are about *club goods* that are essential for the elite but of little significance for the rest of society. Thus, economic assets controlled by the elite could require specialized public factors of production – one can think about an economy with a large resource sector owned by the elite, in which case such factors of production could be infrastructure of resource industries, e.g. pipelines. To make the discrepancy between institutional needs of the elite and the rest of society particularly stark, assume, as in Acemoglu and Robinson (2007) that elite and citizens take utility in different and non-overlapping types of public goods. In that case the elite would not waste its political resources on policing institutions that they don’t value, and will instead use its influence to maximize the supply of its exclusive “club goods”. Consequently the provision of general-purpose institutions suffer – such institutions can be misused with impunity – not just because they have no advocates and guardians, but because elite’s influence leads to re-deploying public resources from general-purpose institutions to exclusive club goods, and such pressure is not counterweighed by broader-based constituencies. Two models can be used to illustrate this outcome.

In the first model elite lobby the government from *without*, and their lobbying is described by menu auctions (Grossman and Helpman, 2001). Suppose that social welfare allows the following representation: $W(t, G_1, G_2) = (1 - t)[Y_1(G_1) + Y_2(G_2)]$, where part $Y_1(G_1)$ accrues (before taxes) to the elite and depends on club goods G_1 , and $Y_2(G_2)$ – to the rest of society and depends on the availability of general-purpose institutions (public goods) G_2 .

Both production inputs G_1 and G_2 are funded from tax revenues with tax rate t , and satisfy a budget constraint $G_1 + G_2 \leq t(Y_1(G_1) + Y_2(G_2))$. If there is no lobbying, the government would choose its policy (t, G_1, G_2) to maximize W subject to the budget constraint, and would supply both production inputs at socially optimal levels G_1^0, G_2^0 , such that $Y_i'(G_i^0) = 1, i = 1, 2$.

Suppose now that the elite are organized in a lobby and offer the government a contribution $C_1(t, G_1, G_2)$ depending on policy choice, whereas the rest of society is unable to solve a collective action problem and stay unorganized. In that case the government chooses its policy by maximizing $W + aC_1$ with some $a > 0$ (characterizing government's susceptibility to influence), subject to the same budget constraint. In equilibrium lobby's contribution function is *locally truthful* (Grossman, Helpman, op. cit.), i.e. has the same marginal rates of substitution between policy instruments as in the lobby's utility function $W_1 = (1-t)Y_1(G_1)$. This leads to an equilibrium provision of production inputs G_1^*, G_2^* , and one can easily check that $G_1^* > G_1^0, G_2^* < G_2^0$. It means that elite's club goods compete with general-purpose institutions for tax revenues (which proxy in the model government resources available to supply and sustain an institutional setup) and thus *crowd out* the latter. This translates into lack of protection of institutions-public goods by those holding controlling stakes in shaping the institutional setup.

Another model, based on (McGuire and Olson, 1996) describes impact on institutions from *within* the ruling coalition. We retain the assumption that the economy consists of two sectors requiring two different types of public goods (institutions), but in the present setting taxes entail deadweight loss so that the tax base is $r(t)(Y_1(G_1) + Y_2(G_2))$, where function $r(t)$ is monotonically decreasing and such that $r(0) = 1, r(1) = 0$ (in the model originally presented in McGuire and Olson, op.cit. there is a single public good, otherwise the setups are identical).

Socially optimal (second-best) policy (t^0, G_1^0, G_2^0) can be found from the following problem:

$\max(1-t)r(t)(Y_1(G_1) + Y_2(G_2))$ subject to budget constraint

$G_1 + G_2 \leq tr(t)(Y_1(G_1) + Y_2(G_2))$. Government-“Leviathan” that maximizes its tax revenues

net of expenditures on public goods will be solving the following problem:

$\max tr(t)(Y_1(G_1) + Y_2(G_2)) - G_1 - G_2$ (formally subject to the same budget constraint

which is however obviously non-binding and thus can be skipped), and in the choice of such

government t^*, G_1^*, G_2^* the tax rate will be higher and both public production inputs

usually supplied at lower levels than in the social optimum.

McGuire and Olson noticed that when the ruling coalition owns market assets and thus has another source of revenues in addition to the state budget, this better aligns its incentives with economic efficiency and brings government choice closer to the social optimum, making it fully (second-best) optimal once the ownership stake of the ruling class hits a certain threshold that does not need to be particularly high. Such outcome is due to elites’ self-restraint in choosing tax rates (since they directly feel the tax burden) and their increased willingness to sacrifice the rent in favor of public goods of which they are direct beneficiaries.

This conclusion is valid in the case of a single production input, but an outlook becomes less sanguine if the ruling coalition holds special kinds of assets which require only the club good-type production input. In such case the government solves the following problem:

$\max tr(t)(Y_1(G_1) + Y_2(G_2)) - G_1 - G_2 + F(1-t)r(t)Y_1(G_1)$, still subject to the same

budget constrain, where $F \in [0,1]$ is the share of the ruling coalition in the first sector. Now

one can show that in the government choice the tax rate will be lower than t^* (which is consistent with McGuire and Olson, op.cit.), and the supply of the first production input will

increase, but of the second will actually *decrease* in comparison with G_2^* , pushing the supply

of this input further down and away from the social optimum.

Such outcome is natural, since the ruling coalition still considers the part of the economy it does not own as merely a tax base, and the reduction of the tax rate (out of concern about the coalition’s market assets) diminishes the incentives to spend public funds on production inputs that expand such tax base. This conclusion corroborates the findings in (Robinson, Torvik and Verdier, 2006) that “resource booms” prompts ruling elites to vigorously pursue the “extraction

path” in a close to socially efficient pattern while misallocating resources in the rest of the economy – in our case by withdrawing support from universal institutions making them vulnerable to opportunistic exploitation.

The same outcome obtains – general-purpose institutions suffer from neglect due to crowding-out in elite’s preferences which shape government policies.

10. Incentive to subvert

The preceding section argues that in some cases misuse of institutions is tolerated or neglected by elites. In other cases however the elite itself subvert institutions in pursuit of economic gains. This phenomenon has been broadly recognized and extensively discussed in the literature – see e.g. Rajan and Zingales (2003); Polishchuk and Savvateev (2004); Acemoglu and Robinson (2007). Acemoglu, Johnson, and Robinson (2002) contrast universally available *institutions of private property* that protect property and contracts and maintain level playing field, with *extractive institutions* which earn rent for the privileged elite. When institutions of private property function as expected, they reduce rents for the elite (North, 1990) and hence such institutions become targets of subversion so that they can be transformed into de facto extractive institutions. Przeworsky (2004) similarly points out that established elites rely on exclusive (“inegalitarian”) institutions to defend their privileges. Since institutions of private property are egalitarian in their nature, once they have been formally established (by way of emulation, in response to popular demand, pressure of pro-growth groups, etc. – see Djankov et al., 2003), elites attempt to subvert them to further their needs (Acemoglu and Robinson, op. cit.)

A useful way to think of this phenomenon is to distinguish between *fixed costs* of accessing an institution, and *rents* that such access earns once the “entry fee” has been paid. For institutions of private property such fixed costs are kept minimal, to ensure universal access, and consequently no rent accrues. Extractive institutions, to the contrary, maintain high fixed costs, thus allowing access only to the wealthy, but earn high rent to those qualified at the expense of the society at large which suffers net losses. An institution can be characterized by a pair (s, r) , where s is the fixed cost, and r – return to assets of the institution’s user. If w is the wealth (value of the assets) of an agent, his/her assessment of the institution is given by $rw - s$. Clearly for two institutional setups (s_1, r_1) and (s_2, r_2) such that $s_2 > s_1, r_2 > r_1$, sufficiently wealthy agents will always prefer the latter; furthermore agents’ preferences over (s, r) meet the single-crossing property and thus if an agent with wealth w prefers (s_2, r_2) to (s_1, r_1) , so will all

other agents with $w' > w$. Wealth thus tilts preferences in favor of inefficient institutions and creates incentives for institutional subversion⁶.

We illustrate such outcome by subversion of regulation of entry mentioned in Section 6 where it was argued that excessive entry barriers cannot be cleared by small resource owners (as in De Soto (2000)) and thus create rent for wealthy ones⁷. Suppose that total stock Z of production assets is shared between the wealthy elite and small resource owners in proportion a to $1-a$, whereas the shares of elite and small owners in the unit continuum of agents are respectively b and $1-b$; obviously $a > b$. Within each group the resource is distributed evenly so each elite member has $\frac{a}{b}Z$ units of resource, and each small owner $\frac{1-a}{1-b}Z$. Resource X in the formal

sector is invested in the economy with production function $F(X)$ and earns the rate of return $r(X) = F'(X)$ which is assumed monotonically decreasing with X .

To enter the formal sector, an agent has to cover the cost s of clearing the entry barriers. The minimal barrier that is required in the interest of the society is $s_0 \geq 0$, but actual s can be set higher under pressure of vested interests, in which case the institution of entry regulation is misused. All agents (as in e.g. Murphy, Shleifer and Vishny 1993) can deploy their resources in the informal sector which offers flat rate of return $p_0 < r(Z)$; this option is available to those who find the cost of entering the formal sector prohibitive. We assume that

$$Z \frac{1-a}{1-b} r(Z) - s_0 > Z \frac{1-a}{1-b} p_0;$$

this means that when entry barriers do not exceed what is required for regulation of entry to serve public interest, all of the resources will be invested in the formal sector.

To see whether the elite have the incentive to raise entry barriers over what is socially optimal, one has to explore the tradeoff between paying higher entry cost and earning rent due to exclusion of small owners who exit in the shadow economy. It can be easily verified that exit of small owners begins with $s = s_1$ and is complete when $s = s_2$, where

$$s_1 = W \frac{1-a}{1-b} (r(Z) - p_0), \quad s_2 = Z \frac{1-a}{1-b} (r(aZ) - p_0),$$

and of course $s_0 < s_1 < s_2$. Clearly s will not be raised by the wealthy above s_2 , and it can be shown that s_2 is preferable for the wealthy to all $s \in (s_1, s_2)$, where partial exit of small owners occurs. The choice is thus reduced to selecting $s = s_0$ or $s = s_2$; in the latter case the institution of regulation of entry is subverted.

To formulate conditions under which subversion obtains, denote $\delta = \frac{a}{b} - 1$ and

$\varepsilon = \frac{r(aZ)}{r(Z)} - 1$; the first of these parameters characterizes inequality in resource allocation

within the society, and the second measures the rent potential by exclusion of small owners. Both factors are conducive for subversion. Indeed denote

$$c \equiv \frac{(1-a)(r(Z) - p_0)Z - s_0(1-b)}{Zr(Z)}$$

gross welfare losses due to exclusion of small resource owners from the formal sector in relation to the total return on the full resource stock. In that case calculations show that the elite will elect subversion if and only if

$$\varepsilon \delta > c.$$

Economic disparity is thus an important prerequisite for misuse of basic institutions of market economy – in (Polishchuk and Savvateev, 2004) a similar conclusion was made with regard to protection of private property rights. This is consistent with findings in the literature that extractive institutions (which are often obtained through subversion of institutions intended to enhance economic efficiency) are likely to emerge and be sustained in societies which are deeply polarized economically (see e.g. Engerman and Sokoloff, 2000). This conclusion is rather intuitive – misuse of market-augmenting institutions leads to net efficiency losses, and if a society is sufficiently egalitarian, everyone would lose in such negative-sum game. Only if inequality is sufficiently profound, there could be constituencies that would benefit from subverting a pro-efficiency institution, and due to “economy of scale” in rent-seeking such constituencies comprise the wealthiest part of society.

11. Incomplete reforms

Misuse of institutions is facilitated by *gaps in the institutional setup*. Institutions are known to oftentimes *complement* each other in that performance of a given institution closely depends on the availability and conditions of the others (Aoki, 2001). The latter could serve *inter alia* as checks and balances preventing misuse of the given institution. Thus, well-established corporate governance and effective and impartial court system prevent misuse of the institution of bankruptcy. A strong and yet constitutionally constrained federal government is required to maintain “market-preserving federalism” and prevent misuse of decentralization at the subnational level, including “beggar-thy-neighbor”-type policies (Blanchard and Shleifer, 2001; Polishchuk, 2001); a well-developed system of political parties works to the same end. Political competition, free media and other transparency-enhancing institutions serve to prevent capture of institutions by vested interests, etc. Without such checks and balances which are present in a full-fledged institutional setup, misuse of institutions can be prevented by questionable heavy-handed measures that restrict access to institutions by bona fide users and often render such institutions dysfunctional.

An incomplete institutional regime could emerge in process of gradual economic and legal reforms where new institutions are supplied in a certain sequence and over a significant period of time. Gradual reforms present an alternative to radical ones, when the required institutions are established quickly and nearly simultaneously. Both strategies have their strengths and weaknesses, extensively debated in a vast literature on the subject (see e.g. Roland, 2000; Polterovich, 2006). Gradualism is usually justified by difficulties in implementing multiple reforms across a broad front, as well as by needs to learn, adjust and if necessary modify earlier blueprints. One of the dangers of a gradual approach is that in the interim it could create opportunities for misuse of institutions already in place.

Hellman (1998) argues that political and business elite are better able to extract rent from incomplete reform and thus stay in the way of reform completion, protracting an institutional hiatus. Our analysis shows that rent from incomplete reform can be extracted through misuse of institutions already in place, so that misuse of institutions and incomplete reform feed upon each other.

12. Concluding remarks

Institutional outcomes are anything but predetermined, and misuse of institutions is one of the reasons of such ambiguity. The preceding analysis suggests that such misuse could be quite widespread with no immediate remedies at hand to stop it. Indeed, without social capital (which in itself is an outcome of development) grassroots resistance to misuse remains weak.

The same lack of social capital does not allow to mount a strong grassroots pressure upon the government so that it could interfere to defend the misused institutions. Politically organized and influential groups are either indifferent to misuse of many institutions or, worse yet, are behind the observed subversion. Besides, government intervention is often too “blind” and works indiscriminately, adversely affecting bona fide users as well.

This leaves no universal “magic bullets” that can be used against the misuse of welfare-enhancing institutions vitally important for development. One can hope that development itself creates more enabling conditions for institutions to function properly, e.g., in Lipset’s (1960) tradition, through accumulation of human capital (Glaeser et al., 2004). This is of course anything but pre-determined outcome, given the danger of “institutional traps” (Polterovich, 2006) and “invariance” of institutional setups adverse to development (Acemoglu and Robinson, 2007); it is noteworthy that such invariance can be sustained precisely through misused of institutions that are expected to eliminate the ancient regime. Furthermore social capital is known to be difficult to instill and nurture by government and donors which at best could support and augment “bottom-up production of norms and networks in non-distorting ways” (Keefer and Knack, 2005, p. 772).

A palliative solution could be to design institutions “misuse-proof” so that “[they do] not depend on absent or weak institutions and [are] insulated from or adapted to perverse institutions as far as possible” (Shirley, 2005, p. 630). This reinforces the general dictum that best-fitting institutions for transition and developing countries should be designed to reflect local idiosyncrasies, including the danger of misuse.

Notes

¹ A similar but somewhat distinct phenomenon is considered in Polterovich (2001), whereby formal rules provide merely a shell which could be filled with behavioral patterns more innate for a given society and leading to disappointing outcomes.

² A. Privalov, *Expert*, № 18, 2008.

³ This is an example of powerful interests’ adjustment to reform that is expected to eliminate earlier available rents. By manipulating institutions those in power are often able to keep their privileges, reform notwithstanding (Acemoglu and Robinson, 2007).

⁴ For other similar “surprises” of transition see Roland (2000).

⁵ Canada gives another example of a “loosely defined” federation, but deeply rooted political tradition on which the Canadian federalism firmly rests kept the country within the confines of the federal system (Polishchuk, 2003).

⁶ This can be interpreted as *increasing returns to scale* in rent-seeking (Murphy, Shleifer and Vishny, 1993); see also Rajan and Zingales (2003); Polishchuk and Savvateev (2004).

⁷ Djankov et al. (2002) consider two possible patterns of regulatory capture – by the bureaucracy operating the entry process (a “tollbooth” view) and by vested interests which are based outside the government but can influence the latter. Our analysis follows the second view.

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