

## **The Lure of State Capitalism: A CRCE Colloquium**

### ***Relations between business and the state in liberal theory, in Russia and elsewhere.***

Chairman: Svetozar Pejovich

Discussion leaders: Olga Kuznetsova & Tomasz Mickiewicz

**Steve Pejovich:** The topic which we shall discuss today is a very important one. The most important problem in this phenomenon is that the company cannot be a legal entity. And because it cannot be a legal entity, it cannot have a law of limited liability. And if you cannot have a law of limited liability, you cannot really have property rights. You cannot do what our corporations have done, to try to pull together the resources of a lot of smaller members, in order to pay major capital holders. But now I turn to Olga and ask her to explore these topics further.

**Olga Kuznetsova:** Thank you. I am not going to start with Russia; instead I shall start with America. Ronald Reagan once presented an epitome of the relations between state and business in one simple brushstroke: “the government’s view of the economy could be summed up in a few short phrases: if it moves, tax it; if it keeps moving, regulate it; if it stops moving; ...”

### ***See Appendix 1 for Dr Kuznetsova’s presentation***

**Steve Pejovich:** I have two questions. The first is would you define what you mean by state capitalism? The second is that you state that poverty in the post-communist phenomenon is a little bit strange – would you explain?

**Olga Kuznetsova:** I had a conversation with my Russian form-master and considered the phenomenon of state capitalism. My belief is that state capitalism has a lot of different forms, and it operates on a two-way basis. The simplest way to define it is: “heavy, significant, visible, economic presence of the government,” and probably there will also be a significant share of state ownership in the state economy, and everything that goes with that. But I tried to find out what they call this form of capitalism in Russia, and the terms they use are “bureaucratic capitalism,” “dirigiste capitalism,” “administrative capitalism,” “manually-managed economy,” “merge of the political power and ownership,” “crony capitalism” – and so forth. I asked my friends whether there are signs of an increase in state presence in the economy, in terms of quantity or quality, and there has been no assessment. Jakob Pave, a

Russian academician, is writing a book in which he attempts to assess whether the state has increased its presence in the economy. At the moment there are no statistics, and we are just guessing.

As for the question on poverty; my assessment is based on the statistics, because we did not really have poverty. Living standards were not high during Soviet times, but I would argue very strongly that we did not have *poor* people; people had pensions, though they were small. People could satisfy their basic needs, and it is not the case anymore. Although, as far as poverty is concerned, we are not talking about extreme poverty – like in Africa – but about the poverty of an ex-middle class. This has completely different implications for society, and probably for society's morality too. This generation is still there, and I belong to this generation that was robbed. All my friends, without exception are millionaires in Russia. But I was educated in the Financial Institute, and this is the main supplier of millionaires to the economy, as now they occupy the banking and financial industry. But if you are simply an academic and you work in academia, you will not be able to survive. This is probably a different sort of poverty because we measure this poverty against the standards that exist in the society – so you will not be able to afford anything; the conditions here have worsened. I have done some research on this, and I can provide statistics that prove this point.

**Richard Connolly:** Thank you Olga for a really interesting and provocative presentation.

I agree with some of the points you make – the general direction of it – but I wonder if you are being a little bit too strong in some of your statements. I am going to pick up some of the issues you listed about property rights. Your first one, the original sin of privatisation – well that applies to a certain section of the economy, but not to everything. If you walk down the street today there is a town, with plenty of shops, so property rights seem pretty legitimate. I agree that in some key areas and strategic sections it is not seen as legitimate; but then I think that that was almost inevitable. You talk about the role of the culture – I take it by that you mean its natural resources. There are two things: Phil has made the point in an article that state ownership in Russia's natural resources industry, compared to other countries with plenty of natural resources, is perhaps not as strong as it could be. So, in that respect it is not as bad as I think you suggest. Second, outside the natural resource economy there are sectors that are growing; there are parts of the economy that are flourishing, in relative terms. So I thought that was a bit harsh.

You talk about the rent distribution and the function that the state performs, and I think that this is quite normal in many low middle-income countries. I am not saying that this makes it good, but it does make it understandable. This is quite normal in a patrimonial regime, such as those in many low and middle-income countries. SMES: you said that the status of property rights is particularly bad. B if you look at, for example, the High School of Economics, whose team examines surveys of manufacturing, their activities – whether they are investing in RnD, in recruiting new staff, and so on. If you read those the picture is actually a lot more nuanced, and it suggests that there is a good proportion of firms – small

and medium sized, some large – that are investing, and obviously secure enough in their property rights to do this. The picture that you paint, one would wonder why anyone would invest at all in Russia; things seems so bleak. Then you call it a “non-system,” which seems really harsh, because we could say that about nearly every non-OECD economy, surely. This is Russia, and I think at times we can be in danger of orientalisising Russia and making it seem peculiar. It is not that different in the sense that it has a government which is performing rent-distribution activities and behaving in a patrimonial manner. This is common in Brazil, in nearly every country in Latin America, in Mexico: there are close links between the state and business. I agree that the state in Russia at the moment is sub-optimal; it is not great, and there is plenty of room for improvement. But I wonder whether you have perhaps not acknowledged some of the real progress that has been made and is going to take some time, as this economy was made only about twenty years ago.

If you look at a country such as South Korea, and look at the development trajectory there, that is a success story which has gone from low-income to just about within high-income. That has taken, what, fifty, sixty years? And in the 1980s, when they were water cannoning protestors and the like, that was thirty years into what was a success story. So given that we have only been looking at development in Russia for twenty years, the progress that has been made is, I think, perhaps more than you have acknowledged in your presentation.

**Silvana Malle:** I think young people should always speak after old people, because he practically said everything that I wanted to say, and said it better than me!

**Steve Pejovich:** So you are going to say it anyway!

**Silvana Malle:** Yes! I want to pick up on the last point that Richard made. It is hard for me to understand why Olga picks up this “non-system” description of the Russian, Russian regime, Russian order. It seems that that is really excessive. What we also saw during the crisis actually was that the power – you can call it authorities, whatever you want – was very clear in picking up what they were labelling “system-forming units;” “system forming”. It is actually unique to Russia and I have not found this expression in other countries. And the system-forming were the large-scale enterprises, mainly state-owned or partially state-owned, large banks and so on. These were the ones that the state came to rescue, not just to subsidise forever, but to enable them to survive the crisis. So I think this “system” is pretty clear. What are the crucial fundamentals of, what I would call, a system? I will discuss tomorrow why I call the Russian system a “corporatist” system, thus I do not want to anticipate my presentation. To call Russia a “non-system” also seems strange to me because this “whatever-it-is” produces growth. It is very difficult for something that does not stick together in one way or another to produce growth. It produced very robust growth until mid-2008. It went through the crisis and the crisis was very brutal. This was not only the case for Russia, but Russia certainly emerged as a country that lost a lot during the crisis. But it is also true that after the crisis this country is growing again not as much maybe – but 3.5% to 4% compared to what is happening in Western Europe is amazing! Finally, I would suggest if

this is a written paper that you define why you consider this to be a “non-system.” In which way the parts of the non-system do not stick together, unless you only want to talk of an unstable system, which is another thing. You could say, “Well this system is there, it is not sustainable, it will collapse”. But that is another story.

**Stefan Hedlund:** I think Olga captures something important when she goes through this list of descriptive labels that we use. I always have had a feeling that there is an inverse relation between understanding and labelling. The more labels we have, the less we understand. I think this is the case when we are looking at whether a system is a market economy, a democracy, and so on – how do we conceptualise what we are looking at? I would suggest, with respect to state capitalism and such, that if we begin by looking at how Russia is ruled, or governed, beyond the government, presidency, Supreme Court, Duma, all these institutions, the real governance is undertaken by a conglomerate of rent-seekers. This small group has very clear interests and revenue streams, and in assets that they have very dubious titles to, so they are in a shaky position, that needs to be defended. These people have a set of values that does not include a whole lot of compassion for the people, nor sympathy for the rule of law. It is not much concerned with what we think about in terms of liberal democracy and a working market economy.

That is sort of the core of the system. Then, another part is obviously the bureaucracy, and if there is one really substantive continuity in Russia it is this bureaucracy. All of the Russian novels, describe the corruption, the lethargy, the possibility of getting work, and so on. And the Russian bureaucracy is still based on the concept of *kormlenie*: feeding – that you get the *de facto* right to pilfer and steal and you are not held accountable. It is known as the “culture of impunity.” We have seen it in the Magnitsky case and many other cases, that people within the bureaucracy share a corporate culture, let us call it, that entails value systems and beliefs that “I have a right to take this and that, and nobody is going to come after me for it.” So we have a conglomerate of rent seekers at the top; and an executive power below. This is to implement their agendas that are completely beyond the rule of law, beyond any form of accountability, imbued with a sense of complete immunity from anything that could happen to them. So that is two parts: and could what is left be called a state? The ideal of a state is a sort of repository of rules. The state has a function to be a third-party enforcer of contracts and property rights and who is responsible for that in Russia? I would argue that that is not currently being filled. If you look at investment, which is really the bridge to the future. Don’t invest, we don’t have a future, very simple. So, is there sufficient investment in Russia? Obviously not – the ratio of investment to GDP is very low in Russia; it is about twenty percent or something (it is forty-five/forty-seven in China). And if you realise that a lot of investment goods in Russia are bought at inflated prices from monopolistic producers, and you recompute at world market prices, then you have a ratio of investment to GDP that is maybe ten or twelve percent, compared to forty five in China or whatever.

It is quite clear to me that there is no such thing as a state that upholds contracts and property rights, in the sense that imbues investors with a feeling of a long-time horizon for investment.

There is a low rate of investment, and if you look at capital flows in and out of Russia, this is very footloose money. What we view as capital flight is largely Russian money leaving from a five-minute holiday in Cyprus and then returning. So when it leaves it is capital flight and when it returns, it is foreign direct investment. I would say that both these capital flows are completely bogus, and we do not really know how Russia really is integrated into the world economy. I would argue that the real integration of Russia into the world economy – beyond pumping and digging – is minute, and these capital flows are very much a symptom of Russian entrepreneurs in various sectors escaping the system. They are staying below the radar screen, evading taxes, detection, and being expropriated – whatever. We picture it as capital flights and foreign direct investments. Is there something in this mess that we can credibly refer to as a state that upholds and fills functions that states normally do – in the way that we present them, in economics, or in political science, or whatever? I rest my case.

**Phil Hanson:** I very much agree with what has been said, particularly by Richard. I was thinking very much along the same lines, but I would like to raise a slightly different but related point, which is this. I think when you talk about a non-system, or a state which is not fit for purpose whether in state-led development or in fostering a market economy, you are saying something like this: there may have been some countries in which state-led modernisation or state-led development worked, but the Russian state is not in a good condition to achieve that kind of thing. I think that is compatible with what you were saying. I just wonder if we do not retrospectively overweight the state machineries of those countries which we perceive as having achieved state-led development. There have been studies of the Ministry of International Trade and Industry in Japan and its policies, which suggest that even in the sixties and seventies a lot of the policies they were designing – the different policies – were producing conflicting incentive effects on the recipients. And the success comes from something other than what the state machinery is. It could be that the state machinery everywhere is not very good. I am sure that there are variations everywhere, but I just question whether the particular condition of the Russian state is such that it could be called a “non-system”. I think that Putinism is a kind of system of its own; a very strange one, or a very specific one. I still think we have to try to understand how it is that a number of considerable businesses have developed successfully in Russia. This is picking up on Richard’s point – I mean, the Andex-Kaspersky Lab, X5 retail chain, Windmill Down until it was taken over by Pepsi Cola. There are a number of countries which have done very well developing in Russia. Your picture is such that it would appear to be impossible to do that, but they have done it. So I just raise the question: isn’t this in some sense a functioning system? It is not a well-functioning system, but it is a system. I think we would agree that it needs to be changed – or should ideally be changed, but it is not a complete dead loss.

**Krassen Stanchev:** Okay, so about the poverty issue... I lived in Russia during the second half of the seventies, and I had the impression that folks there were much poorer than us in Bulgaria, while we in Bulgaria were much poorer than the Yugoslavs, and the Yugoslavs seemed to have been living better than many others.

At the conventional measure of poverty is, and the commercial measure - two dollars of income a day per person – the USSR in the second half of the seventies with its one hundred to one hundred twenty five roubles average salary seemed very misfortunate in international comparison. (The exchange rate which is now available – the historic exchange rate of those years, it shows that with this average salary it makes that less than two dollars a day must have applied to a large segment of the Soviet population. And these were “good years” of the seventies, just before invasion of Afghanistan and the collapse of the Brezhnev era. I think that the fact the Soviet Union was a poor country is statistically justifiable.

Certainly, there is a system in Russian governance. It is not as strange as people used to think, and I do not think that it is government or coalitional rent-seekers. I mean this is a coalition of rent-grabbers. These are people who simply grab. And here comes the control of assets issue. You do not need to be an owner of something provided you own the courts: so you can manipulate the property rights as you wish. So in this respect it is a very ridiculous and strange system, but it is a system. It is a “systemic system”, as Russian dissidents use to name it in 1970s – whoever is outside this control function is anti-systemic.

That is why the current government of Russia does not make any distinction between, let’s say, Kasparov, Limonov and other opposition movements – everyone is against the system. And that is why they operate in this manner; this is why you have the Magnitsky case, this is why you have the Khodorkovsky case.

During the earlier morning discussions I recall a eighteenth century Russian author, Nikita Panin; he was a Count, well-placed at Emperor’s Court, a diplomat...

In either seventeen seventy-three or seventy-four he was famous for presenting the following argument for reform in Russia.

He said, “In Russia, those who cannot plunder, they steal.”

So this was a key argument for reform then; this was an argument between two parties, obviously from aristocratic segments of society; and Panin actually tried to convince the young Emperor Pavel to follow some sort of a reform, and he even wrote a discourse on Western civil state laws. And if you look at the book – I have it on my computer; this discourse, this open letter to the Emperor as a rhetoric and vision is basically quite libertarian. Panin advice is: you shall not privatise the government because those who privatise the government, they plunder; those who do not privatise the government, they steal. So, the same system as today seems to have been in place back in 1770s.

**Karl-Peter Schwarz:** I have two short questions, and one remark. The questions refer to the last sentence in your presentation – namely, before you described the effects of state intervention and the heavy influence that the state has in the Russian economy. This is well known. Then you infer that it is a less important state in Russia, so it seems to be contradictory to say that they are underdeveloped in this way.

Secondly, Russia has negative demographic development, and its position as a provider of energy is undermined by technology, so those are probably two long-term developments that

could change the position of the regime there. So how would you assess these and what would be the outcome for the stability of Russia?

My remark: I feel a little bit uneasy with the term state capitalism, because it is ill-defined. It means not only the presence of the state, intervention of the state; is it state capture? It does not say much about the relationship between the oligarchs and the state; my impression is that it does presume a relationship on the one hand with business groups shaping or acting in a way that shapes their interests. On the other hand we have some nominated groups in decision making and I am not sure whether the term “state capitalism” is useful to explain what is happening.

**Peter Mihalyi:** I would like to continue with the position Phil introduced, that basically the state’s industrial policies, the state’s development policies, were not working anywhere else either, and in that sense Russia is not an exception. I cannot do very much with this. However, the next question is, how does the Russian state differ from Poland, or Hungary, where such things also exist, state intervention, state policies? Two things are important here. One is that the Russian state very much wanted and wants to determine income and wealth distribution within the country. I think both of you also alluded to that. The rich people – the *oligarchs* - were picked up by the state, and certainly that was unique in Russia; you do not find that in Poland or Hungary. Essentially this is because in Poland and Hungary, Romania, Bulgaria, there are a lot of foreign firms, and being a manager of a foreign firm means that you can have a nice life. In fact if you are a CEO of a German bank in Hungary, your standard of living is much higher than almost anywhere else.

But more importantly, the Russian state wants to pursue foreign policy with economic means, and that is something that Poland or Bulgaria or Hungary have never ever attempted to do. Of course anyone who speaks Russian knows this differentiation: “near abroad” and “real abroad.” Obviously you need all the resources in your hand, if you want to keep the Ukraine and other former Republics under your control – at least to some extent. But Russia has higher ambitions than that. Russia - through Gazprom – is playing a role in Western European economies, too. So the moment that the Russian state has such ambitions, of course it needs to control the economy. But there is a price to pay for this in the form of forgone profits. And as long as the Russian people like to see Russia as a foreign policy power, they must accept the price, too. Whether it is a good deal for them or a bad deal is another matter.

**Laszlo Csaba:** Basically on the “non-system.” To my knowledge this was a term used by Robert Tiffin to describe the global financial system in the 1970s. Putinism is not as special as sometimes claimed; it is to a large degree back to normalcy, back to a one and a half party system, and state management, and you know where things are being done at least in principle, whereas there is a lot of room for bargaining and otherwise. So perhaps a system is not for this historical conjecture.

Now it has already been mentioned, but I think it is quite important to invoke those more popular terms in international political economy; like “state capture” and “state failure” – and once we involve these ideas, Russia becomes less and less unique. It is beginning to resemble a Latin American economy more and more; with a weak state and a lot of ambition. Of course there is a difference between being ambitious, or being active, and being effective. So in this respect it is more of a Latin American state than a Western European one. Perhaps we are falling into our own trap by trying to understand Russia in terms of a European hub, to think of Russia as a standard or ‘normal’ European country; which is a normative rather than a descriptive statement.

On investment rates, which I think is quite important, the average investment rate in the OECD is 22%, so 20% should not be low, unless you have a notoriously weak and inefficient system of allocation. This is an issue which has not been mentioned and could be expanded a lot. Now, inward and outward foreign direct investment has been mentioned. In short, if you take this rule of thumb, over the last fifteen years capital flight of Russia – not just direct investment – is in the range of six to eight percent of GDP whereas inward direct investment is in the range of two percent of GDP. This tells us a lot. At one point I remember we were sitting in Brussels with a Russian sociologist who said, “Okay, what does this demonstrate?” And we were saying, “Okay it is pathetic, it is problematic, and all this”. He said, “No, it shows that Russia is still largely, at least in terms of the capital market, a normal country. Capital flees from places where it is being harassed to places where it is not being harassed! And of course there are very severe implications for the macroeconomic

Olga’s presentation, benefitted me a lot. We have had a lot of definitional debates. If we talk about Russia, the Russian state, Russian business and state capitalism; which is the dog and which is the tail? How can we know that when we talk about this interrelationship between business and administration. They are intertwined, but it might be useful to know which is the dog and which is the tail.

**John Moore:** I want to make a remark about the discussion of systems and the definition of state capitalism separately, but related. And we have not really got to any agreement on what we mean by state capitalism. Olga suggests: 1) a significant economic presence of government; 2) a significant share of government ownership in the economy. You know by that definition, we are all kind of state capitalists now.

In the US there is certainly a significant involvement of government in the economy, and there is an increasingly significant state ownership in the economy. So it makes me wonder whether there is some kind of a “good” state capitalism, or some kind of a “bad” state capitalism. Whether we want to somehow draw a line there, that says yes, Russian state capitalism is something we do not want. American state capitalism in my mind is also something that we do not want, but nevertheless it may be better than Russian state capitalism! But in any case it seems that we may be making a normative judgement when we are talking about this definition of state capitalism. Similarly with systems; I mean there is a

system in Russia, in the sense of there being a set of institutions that interact together to produce outputs that are observable. They are performing a variety of such functions. I do not think there is a question whether Russia is a “non-system” in that sense; it is just that they have a system that may not be a very good system. So again, are we really talking about a definition that involves something like identifying a legitimate system versus an illegitimate system; a desirable system versus an undesirable system; are we letting such normative judgements creep in to the discussion of whether there is in fact a system?

**Steve Pejovich:** Thank you. Now before I ask you to reply to the comments, I think that I would like to add a comment of my own. I could be a discussant too, I presume. And not to first go along with John, to say; you did not really, Olga, to tell me that state capitalism is more government. System by system must have a set of formal and informal institutions that have economic implications, and you have to define those institutions. Then, you also told us that well-defined property rights are important. Well you know, property rights have been well-defined in most Central and Eastern European countries, and the consequences were far from those that we observe in the West. So there must be a reason, which is that defining property rights is not enough. To have the expected consequence they must be credible and stable. Credible means people must believe that they will be enforced, and stable means that they are not going to change from one year to another. By the way Stefan, what you said about investment: I think that the rate of investment is important, but suppose now that France invests 20% of GDP, and Germany invests 15% of GDP. Are we to assume that the French are creating more wealth for the future? No – it depends on the incentives, the type of those investments. I think before the Soviet Union was investing huge amounts of money, and wasting most of it whereas the United States was investing never more than 15%, and look what has happened. How incentives guide investment is as important as the rate of investment. I believe.

**Silvana Malle:** I have one question, particularly to Olga and Stefan, who have a similar approach to Russia. Do you think that the WTO should not have admitted Russia on the basis of what you say, property rights, all of these things?

**Stefan Hedlund:** I do not think that it would make much of a difference, actually. This business that the WTO is going to discipline Russia is not something that I believe in. And given that pretty much all that is important in Russia is not part of the WTO anyway, I mean prestige is very important on that count. But the impact on the Russian economy, no matter how financial markets calculate that this will have x impact on growth over the coming twenty years, I do not really agree very much, but politically it is important that they are part of the club.

**Silvana Malle:** No, no, but it was not for Russia it was for the WTO. The WTO is the worst organisation – we lay down the rules, the requirements, property rights: all these “goodies.”

Now these are “baddies” and now we admit these bad countries. Who are we? Now, that is the question.

**Phil Hanson:** If you look at the alphabetical list of WTO members: Albania, Angola ... and it ends with Zimbabwe.

**Olga Kuznetsova:** Well, I feel guilty to a certain extent, because it was not an article that I was trying to write, or even a paper. I thought that my mission was just to present a number of points, based on my previous observations; in order to initiate a discussion and maybe provoke people.

**[Several participants]:** You succeeded!

**Olga Kuznetsova:** I totally agree with all of you who said that we need to start with a definition. This is a basic rule of any academic. Unless we are certain about the definition, it is very difficult to conduct a discussion. But I did not really want to talk about state capitalism. I wanted to show that there is a demand for the state in Russia, and at the same time there is something that prevents the state from acting successfully within the economy and the reasons for that were probably my main point. I agree with you that Putinism may be a system, and when I use the word “non-system” I only refer to the fact that there is still institutional uncertainty in Russia because when communism collapsed, old institutions also collapsed overnight. It takes time for new institutions to be developed and implemented. And what happened to the people and the businesses and those who were in the system? They had to rely on their instincts, or they had to invent institutions and they resorted very much to the informal rules and something that was familiar to them. That is what I would call “non-system,” because informal institutions are an important part of our lives. But if you want to have the whole economy in your hands, you need to find the tools to make sure that there are rules, and they are equally available to all participants.

So of course a non-system can produce growth – why not? Because many things can happen in spite of a situation. When you said that we have seen the development of small businesses and economic growth, probably it is in spite of the situation. Something is happening – but are we in control of what is happening? Probably we do not need to be in control, so this would be a more inefficient society.

More questions of course, and whether I made a harsh assessment. Well, I do appreciate the developments that have happened in the country, and actually if we look at some data and evidence, the management in the state sector has improved dramatically. Everybody would confirm that; it would be difficult to deny. But there are still serious concerns with regard to the property rights. They cannot be enforced, and are not enforced on many occasions. And that is why – I think, Phil, you mentioned it in your presentation on Putin’s system – you mentioned this “Truk Dial-up” as a successful company. Where are they now? They have

become a part of this [bed bunk], which is the Russian way of organisation. Why is that? They are very successful, yes, but it is better to be a part of the system. So they have kind of incorporated themselves – again, because they have very good connections. So they are a part of this [bed bunk] which is the biggest banking institution in the country.

There were some discussions or conversations about investment flows. The Russian market is not normal, and it is not usual. It is a very original market, because the majority of the investments come in petroleum form, and there are no other countries in the world that have this balance. That is why it is hot money, and why when the crisis started Russia suffered quite a lot, because this hot money left Russia. The petrol investors had to leave Russia, and actually they are much more sensitive to what is written in the newspapers and they are very sensitive to rumours. So the Russian financial market is volatile and very unstable. Foreign investment in Russia is mainly Russian money which has left the country and then returned.

Another interesting issue, that of state capture, has been mentioned here, and I agree with what has been said. But we do not need an impotent state, we want a strong one that can resist this state capture, and make and enforce the law. That was my point. So it is all about institutional development

The final point was demography, which I cannot comment on. I do not think that I have any sufficient expertise to comment on the demography and the future of Russia. What I do know for sure is that nationalism and this nationalistic mood is very strong there. Many do not want foreigners coming; whoever these foreigners are. So they have to rely on a poorly-educated generation, and so on. But I cannot comment further on this.

Another point was – I have to thank you, Stefan, because I agree with what you said, that “the state is not fit for purpose” in Russia. But is it a state? I do not know. I would tend to say that it is the institutional environment. But who is in charge of the institutions? Are they managed naturally? Because I have a quote from Kenneth Arrow somewhere, who said that the state is expected to supervise the operation of the existing elements of the economic system, whilst gradually allowing them to be replaced with new entrants. So that is the position of the state. Did I cover everything?

**Steve Pejovich:** Yes, but one more question. You talk about [very competent] state managers. What incentives do they operate under? What are the incentives that really work? Because they determine the outcome.

**Olga Kuznetsova:** I think the management has improved, because before that the approach was, “I am the owner and the manager, and I do not need to know anything about management.” Now, companies are happy to invite management expertise and perhaps managerial professionalism has been recognised as something useful. So in this respect management has improved, because probably now they know what they are doing.

**Steve Pejovich:** Yes, but what incentives do they have to do whatever they are doing? I am referring to the Ludwig von Mises debate, showing that even the most perfect manager in the state will have incentives that are not consistent with the creation of wealth.

**Olga Kuznetsova:** Well I think that is right ... Managers are not there to create wealth for the society. So we cannot expect them to do that. But at least managerial teams that are invited to run Russian state companies now are more professional. They do what is expected within the framework of managers. Before that it was just a guess and a hope. Whether they are creating wealth for society is another thing – well, in an aggregated way, perhaps they are.

## ***Part Two***

Chairman: Robert Reilly

Discussion leader: Tomasz Mickiewicz

**Bob Reilly:** I asked what you thought of Watergate. And the reaction I enjoyed the most came from an Italian, Silvana. We said: “This Watergate that has happened in the United States what is your reaction?” And he shrugged his shoulders and said: “That is what you get when you have a government!”

That may be an answer to John’s question about whether there is a good state capitalism or a bad state capitalism. We of course have had some experience of that in the United States under the current regime, where the definition of it is simply that the state guarantees or the state loans or directs state investment; certain forms of energy – Solandra being one of the more notorious investments by the Obama administration, which the market was still able to discipline through bankruptcy. But as the embrace of the state begins to increase in our country, of course that will no longer happen, and large funds will be poured down the rabbit hole – depending on the outcome of the election we are facing today.<sup>1</sup> So, I was so glad when I asked Tomasz what he was going to speak about, and he said corruption. I thought “Wonderful! That fits perfectly with my opening remarks.” So I turn it over to you.

**Tomasz Mickiewicz:** Thank you very much Robert. It is a privilege.

Yes, I did some research a few minutes ago using Google images – and I looked for the word “corruption.” And the very first picture I came up with is this one; which fits my purposes very well. But I have also noticed that it comes from this website which links with south-eastern Europe. So I think that it is somehow relevant.

There is a reason why I prepared my talk on this topic. We finished a year ago with a discussion of corruption, and we could not quite sort it out. We could not quite sort out the question whether corruption is efficient under certain circumstances; and I felt that was a discussion worth continuing. So I did something brave and you are free to judge whether that was a failure or not. I thought of discussing corruption in a general way, in a framework of opportunism. I have written a few academic papers on corruption. The most quoted paper is on Russia, and there is in fact quite a lot on corruption in that paper. Well, the distinction between the concept of opportunism and immoral behaviour is a very difficult one. Many of those problems will be there because someone did not behave in a moral way. But how should we judge cases of simple laziness, for example? The contracts are not complete and that leads to opportunism. I am not sure if there can be a reason, a reasonable moral reason, to judge every case of opportunism or not.

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<sup>1</sup> 5 November 2012 Barack Obama was re-elected President.

*See Appendix 2 for Professor Mickiewicz's presentation*

**Bob Reilly:** Whatever instance you offered us; it was of a person behaving immorally. Either taking from the principal, or taking from another agent.

**Tomasz Mickiewicz:** I would agree with this. I would just say that in some incomplete contracts, it would be difficult to draw a line. Because the contracts have been incomplete, and one could cite examples where it would not be obvious where immoral behaviour starts. But yes, I would agree with this. Yes. It can be taken from this point only.

**Silvana Malle:** Would Olson's "bandit state" somehow apply better to that sort of government, that is an alien government, because it takes your money – your taxes for other purposes than services to the population? Would that fit your efficiency conclusion on corruption?

I am thinking at the moment of our government in Italy – Mario Monti's government seems to be one of the best. It is skimming us, down to sucking the blood out of us. Monti started taxing anything could be taxed away in order to rebalance the budget, which means to pay each year eighty billion *Euros* – not dollars – to these damn investment companies of which we talked earlier, such as Goldman Sachs and similar. If this is what the government does, should I pay my taxes to this government or not? This is a question many honest citizens start asking themselves.

**Tomasz Mickiewicz:** Yes, the question is absolutely spot on. Because I made it easy for myself by using two extreme polar cases, then the choice was obvious. This one is in the middle. I would say yes you should pay your taxes, unfortunately. We can go one level up [from individual decisions on paying taxes to decisions on the shape of taxation], but you are also asking what is the alternative? Here is the alternative, and there is a deliberative process there. You can change your government, you can change your constitution, and you can arrive with somebody better. There is a democratic process.

**Silvana Malle:** No, it is not democratic; it is a technical government, not a democratic one. It is a government installed by the President.

**Tomasz Mickiewicz:** No, it is a legitimate government, which can be changed; and basically there may be short-term benefits from not paying taxes, yes, but the wider benefits from paying taxes are there. Corruption is actually dangerous in the sense that it makes the inefficient government more stable. That is the main problem with corruption; this "greasing the wheels" argument, that in the short-run it may appear as efficient. In the long-run corruption is precisely what makes the inefficient structure more stable. That is the danger.

**Krassen Stanchev:** What you say Tomasz is very interesting but I miss something. What I miss is the payment, the incentives.

So, take the example of, say, Warsaw ghetto policeman who is bribed to save Jews. Sooner or later the rational calculation would lead the policeman to a situational choice. If he continues saving Jews, eventually he will be the one to be dispensed, to be fired. So he has to maintain the violence in the system, in order to maintain the opportunity to be bribed. This is the very important temporal dimension, I think. So if you have an act of transaction, you know that is one thing; but if you have positions – societal hierarchies and relatively fixed positions – then the repeated transaction is something which is a very important element of everything.

And another important thing is that the government comes into the argument at a very late point. But depending on how you understand the government, the previous explanations – the cases – may have a very different meaning.

So the key description of the government would be the position of a policeman in the Prisoner's Dilemma. If you take the two definitions of government: one is the monopoly on use of legitimate means of violence, and the other one is ability to live at somebody else's expense. Sooner or later you have a two-dimensional government, which is a legitimisation of these two positions: the legitimisation of the position to bribe, and to exercise violence. So in this situation each and every individual operating in certain social circumstances – as you said, the government is always there – so the government is probably a different case of corruption than the non-government cases of corruption which are typically indicated by the Association of Certified Fraud Examiners. This is something that is happening within the firm; and the employees of the firm basically corrupt the firm, and they diminish its efficiency. So the case there is clear – the Association of Certified Fraud Examiners, they do a research every year – what is the *detected* crime within firms?

And they can measure it because this is a firm, and you have clearly-defined property rights. When you go into government you don't have these definitional clarities, and you have all sorts of Prisoner's Dilemmas. You have good cops, bad cops, and that sort of stuff. So eventually the definition of good state capitalism is the government as a good cop; and the definition of bad state capitalism is the government as a bad cop – and that is it.

**Karl-Peter Schwarz:** Well, I suppose it is all right, if you only want to shake a little bit this hypertrophic confidence in the state, which has appeared during these discussions, particularly regarding taxation. I think that taxation is fundamentally immoral; every kind of taxation and no exceptions. Why? Because it is not a contractual thing, you do not make a contract with someone who provides you with certain goods for which you pay. But you are forced to pay something for goods when you do not even know whether they will arrive or not. And why is this possible? It is possible because we have this distinction between the public and the private law. So the obvious solution out of this dilemma would be the abolition of the public law, and the organisation of a free society based on private law would be the outcome of this. This might sound off-topic, but I think that at least we should make clear certain distinctions. The fact that you can vote or not vote in a government – whether it is

democratic or whether it is authoritarian – is absolutely secondary, regarding the position of the state on public law, and the possibility to enforce what the interest of the state is.

So, that is the theoretical part of my intervention. The second one is of an empirical kind. Thirty years ago, when I was a young journalist, I made a documentary film about the shadow economy in Naples. I observed these people in the illegal selling of cigarettes, and whatever. One episode that I particularly remember was with a parking lot on a street leading out to the hills nearby. By the kerb was a parking space, and I parked my car there. It was a public space as it was part of the street, and the kerb was rather large. This was used as a parking space, but it was well-organised because there was a guy nearby who would advise how to get in and out, who would watch the car and so on. Thus I felt very comfortable. Although I did not do it, I saw that many local people even gave him their car keys. So if necessary he could move out or back and so on, and it worked perfectly. I asked him “Is this a private parking space, or are you from the city, or what is this?” He said “No, no, this is a public space.” So I asked him “Okay, but do you pay anything for this?” And he said “No, no, I do not invest anything.” “But why then do people pay you?” He answered, “Well, because they are gentlemen!”

I thought this was an excellent answer. But an interesting point is, that in the absence of the state this, public space would have been his property in the meantime. He would have rented it, and made a business out of it. It would have been much better organised than the municipal parking places in Naples which are completely chaotic. So, if you install property rights and do so openly, people are also able or willing to accept this kind of exchange. He provides a service, and he is paid for it. I found this a remarkable example of the market economy and how it works.

**Bob Reilly:** Okay, anyone with a quick intervention?

**Peter Mihalyi:** Just a quick one. I have just returned from vacation in Morocco, where I rented a car. When I got the rented car, the rental office manager told us never to leave the car in an unprotected place, which at first we did not understand. But after the first day we understood. Everywhere in Morocco the following system operates. There is a guy in a yellow jacket, collecting money totally illegally according to your property rights concept. But – and this is where I want to come back to the presentation –this is the norm in every street, every corner. It works very well, because I am responsible for the car, I am happy to give these guys money to protect the car it then, it is not corruption. So the question is generally, but I think also in Tomasz’s presentation, what is corruption? What I would say as a general definition, corruption is a behaviour which is not general. It happens selectively in certain markets at certain times. So the Moroccan car park supervisor is not a corrupt person in the eyes of the Moroccan people and also not in mine although what he is doing it is not legal. The next question – although it might make us jump ahead a bit – is whether this system is effective or not, and whether or not properly-organised systems would be better.

**Roger Sandilands:** I would like to relate this part of the case study a bit to the more general question of how you would regard the case of the black economy. Namely I refer to the example of people using cash to purchase the services of carpenters and bricklayers and so on, in order for there to be a mutual favour between the two parties, in the sense that this is a way to conceal the payment of taxes, if you pay with cash rather than by cheque. This brings me to the point that Olga raised at the very beginning of her talk, when she mentioned Reagan's ditty about "if it moves, tax it." In this case the services of the electrician or the carpenter etc. can be concealed, and these people can move. If they tax it, the higher the taxation is. It has been demonstrated that the higher the rate of the incidence of the black economy – paying by cash rather than cheque. So it seems to me that this is a case where the parking lot is peculiarly a good subject for taxation as compared to income tax – the work of carpenters, electricians and so on. Whereas, the parking lot is something which cannot be concealed as it cannot move, and if it is taxed, the incidence of taxation is relatively certain. From a more fundamental ethical premise about the nature of the land on which we all have to work, space and nature in general: it seems to me that whereas something like a parking lot has supposedly no cost of production except for maybe resurfacing, nonetheless huge revenues can be generated as a kind of monopoly rent – Riccardian monopoly rents. And these monopoly rents are the end-result of community action rather than the action of the owner of the parking lot – apart from the fact that he may have resurfaced it and hired an attendant to collect the money. Beyond that, there can be huge gains owed to the resource cost of production. That should be the ethical basis for an uncorrupt fiscal system, or governmental system – contrasted to one where government relies so predominantly on taxing our work, and the results of our work and our enterprise. It should perhaps rather rely on the community-created Riccardian surplus values, as is illustrated in the parking lot case.

**Silvana Malle:** On this scenario of the parking lot, which is really fascinating, maybe what you said is true but the incentive of the municipality, which is usually in charge of these places, is not to create more parking places. Because by making this resource scarce would increase its price, and in turn increase fines, taxes and so on. This is exactly what happened in Italy.

**John Moore:** Parking has really got scarcer. I read about this private collection of fees in parking lots near baseball stadiums; in parts of town where there seems to be hazard. If you leave your car on the street, there is usually someone there who is willing to take your money and protect your car. It seems to work pretty well. But on the other matter, the cost of the parking lot, when you think about the operating costs of this, you have to include the opportunity costs of that land. This is of course much more appropriate to a privately-owned lot than it is to a government-owned lot. Because the government does not really feel the opportunity costs; it is only the taxpayer who does, and that is very indirectly. But a private owner should and would consider opportunity costs, and keeping the land at maximum use, rather than next-best use. And that is part of the cost.

**Phil Hanson:** I found your discussion “Unbundling Corruption” very helpful, and I think that it is a very interesting exercise. What I was wondering about while you were setting it out, was how does this relate to the old formula, which I have always liked, that monopoly plus discretion minus accountability equals corruption. This has always seemed to me to be quite a good shorthand guide to at least circumstances under which there would be opportunities for bribes, or the equivalent, to be paid. Now it seems to me that what you were saying was something obviously somewhat different; but that formula – monopoly plus discretion minus accountability equals corruption – clearly and implicitly refers to agents and says nothing about efficiency. But I do not think that that formula is incompatible with what you have been saying.

**Bob Reilly:** And Olga?

**Olga Kuznetsova:** I think that it is a very convincing answer with regards to those who claim that corruption reduces transaction costs, and facilitates transactions. Because you show that corruption has a cost, and that this cost is always social. But you also show that there are private gains and private efficiency; and of course corruption creates a job for intermediation, and these intermediators, they receive private gains. But you also mentioned that corruption is an inefficient transaction because it leaves resources with an unproductive agency. You already mentioned unproductive agents earlier. And the question is, they are rent seekers – we understand that – but the question is: are they unproductive? If you get money easily, you might spend this money easily. So in the long run, for the whole economy, this might be a productive transaction; perhaps.

**Bob Reilly:** And then if I can make a brief comment to something Karl-Peter said, about the immorality of public law – or of taxation to support public law. I was in Baghdad in the spring of 2003, approaching one of the huge traffic circles in the city, which was practically impassable. I also had a shotgun on my lap, in the passenger side, because there was no public law. Now it is not as though there were not people providing traffic direction at the traffic circle – there were a number of them, and they were pointing in opposite directions. So what you had was multiple private laws, and no public law.

**Tomasz Mickiewicz:** I am grateful for all the comments. Krassen made two points: one was that basically every agent has a strategy, and that, as part of that strategy, paying a bribe may induce more negative behaviour on the part of the agent taking the bribe, because that agent may be forward-looking, to get more income. Maybe, yes. And maybe that would also change my assumption about whether we should pay or not. Yes. It is possible. The example that you use, I do not accept it actually. Because the critical issue here for me is the fact that in this example, by paying you are not providing resources to the corrupt government which has also criminal objectives like extermination. So from that point of view I do not care whether that person gets rich or not, because it is still a superior outcome to save a Jewish person by paying to an individual criminal, than paying a corrupt and criminal government which would increase its resources. But I can see your point.

The one about measurement is also interesting. As far as I understood it, the argument is that in the public sphere you often have a problem of measurement. The problem of measurement makes corruption more likely, because it is easier – by definition it makes it less transparent. The goods that are provided by the government are difficult to measure and monitor.

We learnt, in terms of this problem, and there was development. We learnt how to decentralise and delegate some of those functions, which even ten, twenty years ago nobody thought could be provided by private agents. A lot of things in Britain for instance, a lot of public services are contracted out to private agents. So again, it all depends on what our state of technology is at a given point of time.

Now, about the parking space, I could not agree more with Peter. I think this was already the answer I wanted to give. I tried to stress transparency and selectivity – those are the critical issues in corruption, because they destroy the market, they destroy information, and information is critical for efficiency. When it becomes a norm, well yes, the parking lot may be on public land, but it is run efficiently by some private arrangements, everyone accepts the rules, they are all gentlemen, and this is okay – this is basically what De Soto wrote about Peru in 1999. An inefficient state, and then you have a lot of self-regulation. I mean we should not be obsessed with government; government is simply just one solution to the collective action problem. There may also be private solutions, and they may work well.

Now, the most difficult case links with Roger's comment on the shadow economy. It is particularly interesting to assess the data of the shadow economy, whilst there is no precise data on the size of the shadow economy. There are various people who try to assess it, such as Schneider in Germany. What you find is that there are countries like Peru, where most economic activity is in the shadow economy there are countries with relatively little shadow economy, such as in Northern Europe, and then you have countries which are in-between. So you have a large shadow economy and then you have a large official sector. When we plot some of these graphs, we find out that Greece was right in the middle, with a large shadow economy and a large official sector. So expectations are not consistent and transaction costs are high, because you are neither here nor there. When you are in Peru and everything is run by private organisations, you are more or less okay. If you are in Norway, where there is no shadow economy to speak about, you may be okay. If you are in Greece you are not okay, because expectations are not consistent. The system breaks down. There is no one uniform market but two markets. It may still be that there is a superior system of organisation to the one in Peru, but then the question again becomes whether it is feasible. If it is not feasible, then we should live with what is there. The real question is what the alternative is and whether it is feasible. Otherwise the discussion does not make sense. Any discussion only makes sense if we can identify the alternative, and we can ask ourselves if the alternative is feasible.

I am a bit sceptical about the taxation of landowners. When you earn money, the value of the property increases. It is not when you have property, because this is already factored into the price you paid – what you could get when you sell. So it is confiscation when you have a high taxation of land, because it is already there. It is not something you produced, it was there and you paid the price. So I kind of disagree not completely, but instinctively.

In terms of taxing wealth effects: if you take Britain, the government has been cheating for a long time already, because inflation is not factored in. So basically the government is already expropriating wealth in Britain on a massive scale. They are proposing to raise taxes, and then they would be taxing it more. I may be wrong as this is not my topic but I am instinctively sceptical about this.

Monopoly as formula for corruption: I like it, I like it a lot. I was not aware of it, I was blissfully unaware. But then the point I stressed is that even though I study economics, I recognise that our models are too narrow. Because we do not think about knowledge and we do not think about information. This is the narrowness of the neoclassical economics' model. One has to go back to Hayek and then a lot of those questions are better explained when we assume that knowledge can be found from elsewhere, and so on. So that is why I stressed transparency, and then it comes back to selectivity. It is critical who knows what, and it is not captured that well. Now the idea that where people who are efficient can use goods, there is more productivity. There is a beautiful argument in Adam Smith's first book where he says that people who are entrepreneurs already, who are credible in creating value, will use money more efficiently. People who are rent seekers will not. There are beautiful passages in Adam Smith where he talks about cities that actually rely a lot on government, on officials, bureaucrats, and the way that they spend money, or rents in particular. Some of that relates to countries that are rich in oil or rich in resources. You can trace it, there is some regularity. People who have no skills in producing value, also have less skill in using the money they gained in a productive way. There is something there. Again this is where standard economic reasoning would be too narrow, because we would not account for that effect. In a narrow economic reasoning it would not matter how the money would be spent. The problem with this approach is that we assume everybody to be the same, whereas people are not the same. Companies are not the same; governance structures are not the same; individuals are not the same: and the way that we spend money matters. So it matters who has money.

**Bob Reilly:** Thank you Tomasz and thank you everyone very much!